**2014 EIGHTH CIRCUIT JUDICIAL CONFERENCE**

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# FRAUDULENT TRANSFERS AND PREFERENCES: LEADING EDGE CONSIDERATIONS

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# Preface and Biographical Sketch

The presenter, Tom Ashby, extends special thanks to his colleague Baird Holm attorneys Eric Adams and Emily McElravy for major effort on this outline and the underlying research. Mr. Adams and Ms. McElravy are rapidly becoming known for dedication and insight of the type provided in helping to select materials for and write much of the following outline. Contributions by Samantha Ritter, a law student at the Nebraska College of Law and a summer Associate at Baird Holm, to the preference parts of the outline were also valuable and appreciated.

The views in this outline and in any oral presentation of it do not necessarily reflect the views of the presenter's law firm. Legal ethics suggest that, among other duties, an attorney should be prepared to zealously advocate the position of the attorney's client. The presenter believes he and other advocates appropriately could advocate different positions on some of the following topics from time to time, depending on the client being represented.

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"Loan and Credit Workouts: Specific Tips to Enhance Creditor Effectiveness," 2013 (South Dakota Bar seminar materials).
"Charity Care and Community Health Needs Assessment," 2012 (HFMA, Nebraska Chapter, seminar materials).
"Consensual and Nonconsensual Liens on Intellectual Property," 2012 (Commercial Law and Bankruptcy Section, Iowa State Bar Assoc. seminar materials).

“Bankruptcy Ethics: Conflicts of Interest, Attorney-Client Privilege, and File Closing Letters,” 2010 (Commercial Law and Bankruptcy Section, Iowa State Bar Assoc. seminar materials).
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"Patient Account Management to Increase Collections and Understand Risks," 1995 (Iowa Healthcare Financial Management Association seminar materials).
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# I. Preferences in the 8th Circuit: Case Law Update

## A. Ordinary Course of Business, § 547(c)(2)

Section 547(c)(2) provides that a trustee may not avoid a transfer:

(2) to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—

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

(B) made according to ordinary business terms.

11. U.S.C. § 547(c)(2).

a) ***Lovett v. St. Johnsbury Trucking*, 931 F.2d 494 (8th Cir. Minn. 1991).** *Lovett* is frequently cited, even post-BAPCPA, for basic preferences standards. In *Lovett,* the debtor paid the creditor for services under a written agreement, within the 90-day preference time frame. The 8th Circuit reversed the District Court, which had affirmed the Bankruptcy Court's ruling that the payments were not made in the ordinary course of business ("OCB"). The 8th Circuit rejected the Bankruptcy Court's reasoning that the written agreement, which provided for payment within 30 days, should control. The 8th Circuit found the average number of days between the invoice and payment was more salient. The 8th Circuit held OCB is determined by how parties actually conduct business, not the conditions specified in an agreement that the parties rarely followed.

The 8th Circuit used a 12-month look-back period in this case, because that was almost the length of the parties' agreement. The Court found that a 10-day average speed up in payments (62 day average over 12-month versus 52 day average over 90-day period), did not push such payments outside OCB. The Court found that although the payments were made "somewhat sooner" in the 90-day period, the difference was not "sufficiently significant." The creditor's insistence that the struggling debtor accelerate its payments "as much as possible" did not undermine the conclusion of OCB. Creditors urging payment more promptly is not unusual and is not the economic pressure to obtain payment that courts will find excludes payments from OCB.

b) ***Cox v. Momar Inc. (In re Affiliated Foods Southwest Inc.)*, 2014 U.S. App. LEXIS 6571 (8th Cir. 2014).** In the first 8th Circuit decision applying the BAPCPA OCB provisions, the Court explained the amendments and labeled them significant. Under the revised § 547(c)(2), industry standards are no longer a required element; an alternative analysis may focus on the relationship between the parties. BAPCPA changed the elements from a 3-part requirement, to either OCB of the debtor and transferee (subjective test) or ordinary business terms (objective test). Further, rather than presumptively or automatically following *Lovett*'s one-year look-back period, the 8th

Circuit preferred a two-year look-back period for determining OCB in this case. Although the parties had an established relationship with regular dealings, there were only nine transactions in the two years before the bankruptcy. A one-year look-back would have only captured three transactions. The Court found the preferential payment was made in OCB because the average over the two-year look-back was 35 days between invoice and payment, and the preferential payment was made 26 days after the invoice.

c) In the Northern District of Iowa Bankruptcy Court, *Agriprocessors'* series of adversary proceedings provides many recent iterations of the preference standards. To aid in analyzing these preference standards, a basic summary of *Agriprocessors* facts follows:

Debtor, Agriprocessors Inc., operated a slaughterhouse and meat-packing factory in Postville, Iowa, that was predominantly known for the production of kosher meat. Aaron Rubashkin founded and was an owner of Agriprocessors. His sons, Sholom and Heshy Rubashkin, managed the facility. The Rubashkin family was a part of an apparently close-knit Orthodox Jewish community, and several members of the community lent to Agriprocessors in connection with the case. The company declared Chapter 11 bankruptcy in 2008, after a U.S. Immigrations and Customs Enforcement raid that led to numerous criminal charges and financial difficulty.

The bankruptcy court approved appointment of Joseph Sarachek as Chapter 11 trustee. It later converted the case to a Chapter 7 bankruptcy. The trustee filed over 150 adversary claims in courts within the Eighth Circuit against creditors alleging they received preferential transfers. The following cases provide insight into recent Northern District of Iowa Bankruptcy Court analysis of defenses under 11 U.S.C. § 547(c).

d) ***Sarachek v. Lubicom, LLC.,* No. 08-2751, 2013 Bankr. LEXIS 1287 (Bankr. N.D. Iowa Mar. 29, 2013).** The creditor provided advertising, public relations, and targeted market outreach services to Debtor. Debtor paid $60,000 to the creditor prior to filing bankruptcy. The Court held the first part of the test – whether the debt was incurred in OCB – looks at the course of dealings between the parties and their distinct businesses. The second part of the test – whether the transfer occurred in OCB or according to ordinary business terms – looks at whether the transfers were either consistent with the pattern of previous transfers between the parties or consistent with industry standards. In addition to a not particularly interesting ruling on incurrence of the debt as OCB or not, the Court held the creditor failed to show that the debtor's payments, that were not equal to the creditor's separate or combined invoiced amounts, were consistent with previous transactions with the debtor, or that the arrangement complied with the ordinary business terms of the relevant industry. Therefore, the Court held genuine issues of material fact remained whether the payments were OCB.

e) ***Saracheck v. Chabad North Fulton, Inc.,* No. 08-2751, 2013 Bankr. LEXIS 1285 (Bankr. N.D. Iowa Mar. 28, 2013).** Creditor was a non-profit corporation organized for charitable purposes. The creditor's rabbi, director, and CEO orally agreed to make a short term loan to debtor and there were no written loan documents. Debtor subsequently paid $50,000 transfer to creditor prior to filing bankruptcy. Creditor argued that the loan occurred in the ordinary course of business. The Court held the creditor must first show the debt itself was "ordinary for both parties," or if it is a first-time transaction, the transaction must be typical compared to "both parties' past dealings with similarly-situated parties." Second, the creditor must show the transfer occurred in OCB of the parties, or according to ordinary business terms. Creditor was a religious organization, but made seven undocumented loans to other parties in the past. The Court held that the transaction followed the creditor's pattern, however, the record did not provide sufficient information about the previous loans, *i.e.* who received them and whether it was typical to loan to for-profit corporations. Additionally, the Court held that the debtor had a pattern of taking loans, but was engaged in fraudulent activity which could not be characterized as an ordinary course of business. Therefore, the Court held that genuine issues of material fact existed whether the debt was incurred in OCB for both parties. Since this was the first loan transaction between the parties, the creditor could not show that the payment occurred in OCB of the parties. Therefore, the Court held the creditor could show that the transfer was made according to ordinary business terms, however, there was not sufficient information in the record to determine what the industry standard was, and because the loan was undocumented and the terms were unknown, there was a genuine issue of fact whether the transaction followed the industry standard.

f) ***Sarachek v. Schreiber*, No. 08-2751, 2013 WL 1276506 (Bankr. N.D. Iowa March 27, 2013).** Creditor was the proprietor of a catering business that specialized in kosher catering. Previously, creditor purchased meat from debtor. Creditor made two loans of totaling $400,000.00 to debtor in the year leading up to bankruptcy. Each loan was memorialized in a promissory note that required debtor to make regular payments on the principal and interest. The loans were not secured. Trustee sought to recover $115,624.55 as preferential transfers. The creditor argued the OCB defense. The court held that even if a transaction was truly at arm's length, debts from atypical financing relationships are not protected. Thus, the Court held that even if debtor received loans from other customers – and it could be characterized as part of the OCB for debtors, the creditor's prior relationship with the debtor was a trade creditor not a financier, and the record was not clear whether providing such financing was within the creditor's OCB to other meat industry companies. Therefore, the Court denied the creditor's motion for summary judgment on OCB.

g) ***Sarachek v. Luana Savings Bank*, 490 B.R. 852, No. 08-2751, 2013 Bankr. LEXIS 1547 (Bankr. N.D. Iowa Apr. 15, 2013).** Debtor maintained at least two separate checking accounts with defendant creditor's bank. In the ninety days before bankruptcy, the debtor wrote hundreds of checks totaling millions of dollars, for which it had insufficient funds. Generally, creditor would wait on the debtor to provide funds by cash to cover the overdraft, and then would honor the checks. When the debtor did not transfer amounts to cover the overdraft amount before the required deadline, the bank would transfer funds from the debtor's other checking account to cover the overdraft. The trustee claimed that each time a check was presented that resulted in negative funds, the bank was extending credit and the series of repeated overdrafts constituted a series of short-term loans. Thus, when the debtor made a deposit, wire transfer, or other transfer to cover the overdrafts, the debtor was making a payment on the short term loans. In total, the trustee sought to avoid at least $5,145,582.68 for the largest single extension of such credit within the preference period. The Court held that material questions of fact existed about whether the overdraft agreement between the parties was in OCB between the creditor and debtor in this case.

Further, the Court held it was unclear whether the transfers were made according to ordinary business terms or highly unique terms applicable only to this relationship, or even consistently changing terms as the debtor moved toward bankruptcy. Additionally, it was unclear what actions the bank took, if any, and what actions might have been considered necessary in the industry. Therefore, the Court denied the creditor's motion for summary judgment because material issues existed as to what constituted ordinary terms and OCB here.

h) ***Sarachek v. Goldschmidt*, No. 08-2751, 2013 Bankr. LEXIS 4399 (Bankr. N.D. Iowa Oct. 21, 2013).** Creditor was authorized to represent a company that provided ritual slaughtering services for debtor. The transfers at issue consisted of three checks payable to the sole owner and director of creditor. The Court held that creditor provided only four invoices as evidence of the relationship between the parties and none were addressed to debtor. Thus, the Court could not determine the normal billing and payment cycle, or whether the payments met the normal pattern of business between the parties. Further, the Court determined that the creditor offered no objective evidence of the ordinary business terms in the industry. Therefore, genuine issues of material fact existed and creditor's motion for summary judgment was denied.

## B. Subsequent New Value, § 547(c)(4)

Section 547(c)(2) provides that a trustee may not avoid a transfer:

(4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor—

(A) not secured by an otherwise unavoidable security interest; and

(B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

11. U.S.C. § 547(c)(4).

A trustee's recovery is limited to the extent that, after the preferential transfer, such creditor gave new value to or for the benefit of the debtor. There are three requirements to the new value defense: (1) the creditor must have received a transfer that is otherwise avoidable as a preference; (2) after receiving the preferential transfer, the preferred creditor must advance "new value" to the debtor on an unsecured basis; and (3) the debtor must not have fully compensated the creditor for the new value as of the bankruptcy petition date.

i) ***Shodeen v. Airline Software, Inc. (In re Accessair, Inc.)*, 314 B.R. 386 (B.A.P. 8th Cir. 2004).** Creditor provided debtor with a nonexclusive software license under an agreement which required monthly payments and obligated the creditor to support the software on a continuing basis. The agreement further provided that the debtor must pay the creditor a down payment before installation was to occur, as well as a daily amount for each day the creditor spent installing software on the debtor's computer system. However, there was no evidence that the down payment or the daily payment was ever made by the debtor. It was the creditor's general policy to not provide services without down payment and there was no credible evidence that the installation ever occurred. Thus, the Court affirmed the bankruptcy court's rejection of the new value defense and its judgment for the trustee. Notable is the bankruptcy court's disregarding of creditor testimony as incredible, at least partly because the creditor supposedly failed to keep copies of records of the work or payments involved.

j) ***Stoebner v. San Diego Gas & Electric Co. (In re LGI Energy Solutions, Inc.)*, 746 F.3d 350 (8th Cir. 2014)**. This case involved a three-party preferential transfer claim. The debtor's preferential transfer was made to a third-party (also a creditor) but such transfer benefited the debtor's primary creditor. The Court held that in such three-party situations, the new value (either contemporaneous or subsequent) could come from the primary creditor. The Court held this even though the third-party receiving the transfer was a creditor itself, and was the only party sued by the debtor's trustee.

Debtor LGI served as a conduit between utilities companies and their customers. The utilities sent customer bills to LGI, and LGI aggregated a customer's various utilities owed. The utility customers would make payment to LGI for the total. LGI would deposit the payment in its bank account and then send checks drawn on its account to the utilities to pay the customer invoices. The preferential transfers at issue in this case were payments made by LGI to two utility companies, on behalf of Buffets and Wendy's restaurants in November 2008. After these payments, the two utilities continued to provide services to the restaurants. New invoices were sent for these services to LGI, and the restaurants paid LGI the invoice amount, but none of the new money was passed on to the two utilities. These post-preference customer payments are the subsequent new value at issue. LGI made the preferential transfers to satisfy its antecedent obligations to the utility customer restaurants, to pay their outstanding utility invoices. These transfers were clearly for the benefit of utility customer creditors, because the transfers paid their invoices owed to the utilities. The debtor's bankruptcy trustee argued that § 547(c)(4) was limited to subsequent new value that "such creditor" gave, meaning only subsequent new value of the immediate transferees would qualify for the defense. The Court rejected this argument, holding that each utility was entitled to offset all new value the utility customers transferred to LGI subsequent to the preferential transfer in November 2008. Although the holding was limited to the specifics of this case, generally this case interpreted § 547(b) and (c) to permit in three-party relationships new value to come from the primary creditor, even if the third party defendant is a creditor itself.

**Agriprocessors subsequent new value cases**

k) ***Sarachek v. Schreiber*, No. 08-2751, 2013 WL 1276506 (Bankr. N.D. Iowa March 27, 2013).** (*See* above.) Creditor was the proprietor of a catering business that specialized in kosher catering. Previously, creditor purchased meat from debtor. Creditor made two loans of totaling $400,000.00 to debtor in the year leading up to bankruptcy. Each loan was memorialized in a promissory note that required debtor to make regular payments on the principal and interest. The loans were not secured. Trustee sought to recover $115,624.55 as preferential transfers in the ninety day period before debtors' bankruptcy. Creditor argued that the second loan to the debtor, provided new value and thus should mitigate the amount trustee could recover. The Court held that it was questionable whether the new value exception could even be asserted for a subsequent loan to constitute "new value" based on the Code's plain application. Further, the transfers at issue were made after the date of the second loan. The Court denied the creditor's motion for summary judgment on the subsequent new value defense.

l) ***Sarachek v. Crown Heights House of Glatt, Inc.*, No. 08-2751, 2013 Bankr. LEXIS 4765, 2013 WL 5966120 (Bankr. N.D. Iowa Nov. 8, 2013).** Creditor was a company that sold kosher food products. Creditor's sole shareholder was the second cousin of debtor's President. Between 2007 and the debtor's bankruptcy, the creditor made frequent short-term loans to debtor. During the preference period, creditor made approximately 112 loans. The process usually consisted of debtor writing checks from the creditor's checkbook as needed and debtor normally paid the loans back within one to three days. The loan agreements were entirely oral and creditor did not charge debtor interest on the loans. Creditor explained that Orthodox Jewish law would not allow creditor to charge interest on any of the transactions. Creditor argues that it provided subsequent new value to debtor that mitigated the amount trustee could recover from creditor. The Court held that "each transfer must be examined independently" to determine whether or not the creditor later provided new value. The Court determined the parties did exchange some amount of money, but disagreed about the amount, the correlation between loans made and paid off, and the correct method to determine whether the subsequent new value exception applied.

The Court determined that the calculation method was a question of law that the Court could resolve on summary judgment. But factual issues remained whether the debtor actually received any new benefit from creditor, or alternatively whether the transfers were paying off old loans. Therefore, even if the Court decided which calculation method to apply, the Court would be unable to determine which checks to include in the calculation. Thus, a material issue of fact remained and the Court denied the creditor's motion for summary judgment.

m) ***Sarachek v. Cohen*, No. 08-2751, 2013 Bankr. LEXIS 1399 (Bankr. N.D. Iowa Apr. 3, 2013).** Cohen was the President of the Twin City Poultry ("TCP"), a kosher food distributor. Over approximately 23 years the creditor lent to debtor and debtor made loan payments. Trustee sued TCP and Cohen. Creditor conceded that it generally did not make loans to other corporations or individuals, but over the years

TCP made more than 105 loans to debtor. Debtor would request funds from creditor, and TCP or Cohen would draft a check made payable to the debtor and debtor would allegedly repay the loan. There was no particular schedule for payment and each transaction was unique in its terms. The loans had no consistent maturation date and were paid off intermittently. Cohen understood the arrangement as a trade creditor relationship between TCP and debtor. Trustee sought to recover payments totally $265,000 made from debtor to Cohen. Cohen argued, at a minimum the transferee's recovery of a preferential transfer should be reduced by the $115,000 provided to the debtor during the applicable period. The Court held, however, that whether this was "new value" unrelated to debtor's balance sheet was unclear. Moreover, it was unclear whether the transfer to Cohen after the payments is a repayment of that new value or for older debt. Because evidence did not show undisputedly the relation between each of the transactions, the Court denied the creditor's motion for summary judgment.

### C. <u>Contemporaneous Exchange for New Value – Section 547(c)(1)</u>

Section 547(c)(1) provides that a trustee may not avoid 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.

11 U.S.C. §547(c)(1).

n) ***Ries v. Scarlett & Gucciardo, PA (In re Genmar Holdings, Inc.)*, 496 B.R. 532 (B.A.P. 8th Cir. 2013).** The preferential transfer at issue was a settlement payment to a customer, resulting from an arbitration claim the customer had asserted against the debtor for a defective boat. In analyzing the customer's contemporaneous exchange defense, the Court emphasized the requirement that the parties intended the exchange to be contemporaneous. The only evidence offered of the parties intent was the settlement agreement. The agreement provided that the payment would not be made sooner than 15 days after the customer released a lien on the boat, which was being returned to the debtor as part of the settlement. Thus, the parties' intent was that the payment and release of the lien happen at different times, which by definition is not contemporaneous. The creditor also tried to raise an OCB defense because the payment was made pursuant to the arbitration settlement, and arbitration was mandatory in the debtor's pre-printed form sales contract. The Court rejected this argument, finding there was no evidence that arbitration was in the ordinary course of the parties' affairs. Merely including an arbitration clause in the contract did not suffice.

**Agriprocessors Inc. Contemporaneous Exchange cases -**

o) ***Sarachek v. Twin City Poultry*, No. 08-2751, 2013 Bankr. LEXIS 1398 (Bankr. N.D. Iowa Nov. 8, 2013).** Creditor was a kosher meat distributor in Minneapolis, Minnesota that had a long term relationship with debtor. Over approximately 23 years the creditor made loans to debtor and debtor made payments on the loans. Trustee alleged that payments totaling $71,818.81 were preferential transfers. Creditor argued that the transfers were contemporaneous exchanges for new value that would defeat trustee's recovery of the payments. The Court held that, to prevail, creditor must prove (1) each party intended the exchange to be contemporaneous, (2) that it was actually contemporaneous, and (3) that the debtor received new value. The Court held that a debtor who pays funds to a creditor to pay an antecedent debt has not received new value. The Court cited with approval a 2008 8th Circuit case holding no new value occurred, even if the repayment *allows a debtor to participate* in ongoing services provided by a creditor (but where the creditor does not prove any specific ongoing, valuable services). The general testimony by the creditor's President, and the imprecise balance sheet he prepared did not adequately link the payments debtor made with any significant return to debtor of new value. The Court held that without reaching the issues of exchange and intent, the creditor failed to show specific uncontroverted facts showing that "new value" was provided, and thus was not entitled to summary judgment on the contemporaneous exchange for new value defense.

p) ***Sarachek v. Luana Savings Bank*, 490 B.R. 852, No. 08-2751, 2013 Bankr. LEXIS 1547 (Bankr. N.D. Iowa Apr. 15, 2013).** Creditor was a payor bank where debtor had a checking account on which debtor frequently wrote unfunded checks. Generally, creditor would wait on the debtor to provide funds by cash to cover the overdraft amount (i.e., the amount by which the check exceeded the available funds) and then would honor the check. At times when the debtor did not transfer amounts into the pertinent checking account to cover the overdraft amount before the required deadline, the bank would transfer funds from the debtor's other checking account to cover the overdraft. The trustee claimed that each time a check was presented that resulted in negative funds, the bank was extending credit and the series of repeated overdrafts constituted a series of short-term loans. Thus, when the debtor made a deposit, wire transfer, or other transfer to cover the overdrafts, the debtor was making a payment on the short term loans. In total, the trustee sought to avoid at least $5,145,582.68 for the extension of such credit within the ninety day preference period.

The creditor argued it provided new value to the debtor by continuing to extend banking privileges and additional check settlements to the debtor. The Court held that whether all the transactions were substantially contemporaneous exchanges was not apparent. The Court was unable to determine from the record if certain exchanges were substantially contemporaneous, or at a minimum what transfers were linked to each other, how they were contemporaneous, or how they provided new value, and for what amounts. The Court denied the creditor's motion for summary judgment.

### D. <u>Other Preference Cases</u>

q) ***In re Big Drive Cattle, L.L.C. v. Overcash*, 2014 U.S. Dist. LEXIS 80853 (D. Neb. June 13, 2014).** The creditor had an equity interest in the debtor, BDC. The creditor bought cattle that he shipped to BDC for feed and care until they reached sale weight, when debtor would sell the cattle to third parties on creditor's behalf. Debtor would deposit the cattle sale proceeds into debtor's Farm Credit Services' account, instead of a standard bank-based checking account. Debtor would deduct the cost of care and feed from the sale proceeds and then remit the remainder to the creditor. The Bankruptcy Court found the funds were commingled, and thus the payments of the net sale proceeds of the cattle to the creditor was a transfer under Section 547(b) ( "transfer of an interest of the debtor in property").

The Bankruptcy Court found significant that the FCS account was a revolving line of credit, so all deposits were considered payments on debtor's loan. The District Court reversed the Bankruptcy Court, finding an issue of fact existed as to whether funds were held in trust for the creditor and therefore never became debtor property. The Court discussed that it was unclear whether the debtor's treatment of the sale proceeds in this case conformed with prior cases involving auctions, whether the owner of the funds was acting within its rights under an agreement with the sellers. In this case the Court found it possible that the arrangement was that of bailment undertaken to accommodate a part owner of the debtor, and that there was no agreement for the debtor to use the sale proceeds. The Court found it was possible the funds were not commingled but misused to pay the debtor's debts. State law, under the right facts, would permit the imposition of a constructive trust, even though the funds cannot be traced, according to the "swollen assets" doctrine. The case was remanded and remains before the Nebraska Bankruptcy Court.

r) ***Lange v. Inova Capital Funding, LLC (In re Qualia Clinical Serv.)*, 652 F.3d 933 (8th Cir. 2011).** Under 11 U.S.C. § 547(c)(5), the trustee was able to avoid a preferential transfer of a security interest filed by the creditor shortly before the bankruptcy petition. The creditor entered into an invoice purchase agreement, providing debtor financing by advance payment of outstanding customer invoices. As collateral, the agreement gave the creditor a security interest in the debtor's accounts receivable. The creditor filed a UCC-1 financing statement one month before the petition. The Bankruptcy Court and the BAP held that § 547(c)(5), providing for exception from preference avoidance for floating liens, did not apply in this case because the security interest was unperfected until one month before the petition. Thus, the creditor improved its position. Section 547(c)(5) excludes from avoidance liens placed on a debtor's inventory or accounts receivable, as long as the liens do not improve the creditor's position during the statutory test period of 90 days (1 year for insiders).

The case pivoted on the single issue of whether the creditor's position was improved by its perfection of its security interest. The statutory "improvement of position" test compares the creditor's position at different times. One point of time is the filing of the bankruptcy petition and for non-insiders, the second point is 90 days before filing. The Court found that even if it was true that the creditor was at all times oversecured (although not perfected), by perfecting its security interest it improved its position 100% as compared to unsecured creditors. The Court held the "improvement in position" test can measure the relative positions of perfected secured parties.

# II. Some Leading Edge Considerations in Preferences and Fraudulent Transfers

## A. Jury Waivers in Pre-Petition Documents as Binding on a Bankruptcy Trustee

A trustee sometimes requests a jury trial in an avoidance action. Defendants in such cases should be cognizant of jury waivers which may be binding on the trustee. It is well settled that a trustee in bankruptcy stands in the shoes of the debtor, and succeeds to all the assets of the bankruptcy estate. *Stumpf v. Albrecht,* 982 F.2d 275 (8th Cir. 1992). Thus, it stands to reason that an appropriately-granted jury waiver would be enforceable against a bankruptcy trustee as concerns actions by the trustee that sound in contract and are for prepetition conduct by a defendant.

In *Adelphia Recovery Trust v. Bank of Am., N.A*., 2009 U.S. Dist LEXIS 63773 (Dist. S.D. N.Y. 2009), several loan documents governed the relationship between the debtor and the bank defendants. Those loan documents all contained provisions generally stating, "The administrative agent, each lender, each issuing lender and each borrower hereby knowingly, voluntarily, and intentionally waive to the fullest extent permitted by law any right they may have to a trial by jury in respect to any litigation based hereon…" *Id.* at 16. In an adversary proceeding against the bank defendants, the bankruptcy trustee requested a jury trial. The district court held that the loan document jury waivers were binding on the trustee to the extent that they would have been binding on the debtor. *Id.* at 25. The district court thus disallowed a jury on many (though not all) of the causes of action pleaded.

At least one court has applied the jury waiver to Bankruptcy Code-created avoidance actions, not just prepetition causes of action inherited by the trustee. In *Kapila v. Bank of Am., N.A.,* 493 B.R. 878 (Bankr. M.D. Fl 2013), the trustee made a jury demand in a fraudulent transfer case. The fraudulent transfer stemmed from transfers the debtor made to bank creditors under applicable loan documents. Those loan documents contained jury waivers. The trustee argued that the jury waivers were not binding on him because he was asserting a fraudulent transfer claim, not a disagreement arising under the loan documents. The court rejected the trustee's argument. The court determine that the trustee could not choose to not be bound by the loan documents' jury waiver provision on the one hand, while asking the court to consider the loan documents' repayment terms as a basis for the fraudulent transfer claim on the other hand.

In *Kapila*, the court goes so far as to say that "the Trustee is never entitled to a jury trial in an avoidance action. Although a right to jury trial is held inviolate in many circumstances, a trustee loses this right by invoking the avoidance process 'because it directly addresses the property of the bankruptcy estate, the eventual amount of claims against the estate, and the distribution of the property of the bankruptcy estate, all of which involve the equitable bankruptcy process.'" *Id.* at 888. This conclusion is much broader than what some other courts have determined.

Other courts have been hesitant to limit a trustee's right to a jury trial. The trustee in Kapila argued that, like other litigants, bankruptcy trustees have rights under the Seventh Amendment. *Picard v. Katz,* 825 F. Supp.2d 484, 486 (S.D.N.Y. 2011 (finding trustee had right to jury trial on fraudulent transfer claim). "The Seventh Amendment protects a litigant's right to a jury trial only if a cause is legal in nature and it involves a matter of 'private right.'" *Granfinanciera v. Nordberg,* 492 U.S. 33 (1989). "The Supreme Court has already found that actions to avoid fraudulent transfers are legal and assert private rights." *Picard*, *supra* (citing *Granfinaciera*).

However, defendants seeking to defeat a trustee's jury trial assertion have arguments against *Picard*, including the fact that no one apparently presented an anti-trustee argument based on any jury trial waiver in prepetition loan documents. Another way to seek to limit *Picard* is by noting that, in *Picard*, the judge justified his decision on the grounds that the court had granted the defendants' motion to withdraw the reference of the adjudication of the fraudulent transfer proceeding. *Picard v. Katz,* 825 F.Supp.2d 484 (S.D.N.Y. 2011). The court felt that this "substantially sever[ed]" the trustee's fraudulent transfer action from both "the claims allowance process and the hierarchical reordering of creditors' claims." *Id*. at 486. Thus, *Picard* is distinguishable from cases pending in the bankruptcy court—i.e., that have not been removed to the district court—and thus are arguably part of the claims allowance process. *See also U.S. Bank v. Verizon Communications Inc.,* 2012 U.S. Dist. LEXIS 39051 (N.D. Cal. 2012) (rejecting *Picard*).

Leading edge advocates should be aware of the *Kapila* decision and also aware that it may not be followed by all courts.

**B. <u>Sanctions for Frivolous Avoidance Actions</u>**

Some courts have become more sensitive to bankruptcy trustees abusing their ability to litigate questionable claims. Most notably, the Seventh Circuit recently admonished a bankruptcy trustee for bringing a frivolous claim against the debtor's accounting firm. In *Maxwell v. KPMG, LLP,* 520 F.3d. 713 (7th Cir 2008), the court notes that the checks on litigation for companies as going concerns do not apply to bankruptcy trustees. The court states:

The extreme weakness of the trustee's case, both on liability and on damages, invites consideration of the exercise of litigation judgment by a Chapter 7 trustee. The filing of lawsuits by a going concern is properly inhibited by concern for future relations with suppliers, customers, creditors, and other persons with whom the firm deals (including government) and by the cost of litigation. The trustee of a defunct enterprise does not have the same inhibitions. A related point is that while management of a going concern has many other duties besides bringing lawsuits, the trustee of a defunct business has little to do besides filing claims that if resisted he may decide to sue and enforce. Judges must therefore be vigilant in policing the litigation judgment exercised by trustees in bankruptcy, and in appropriate case must give consideration to imposing sanctions for the filing of a frivolous suit.

*Maxwell v. KPMG, LLP*, 520 F.3d. 713, 719.

The sentiment expressed in *Maxwell* has also been applied to trustees' preference actions. In determining whether to impose sanctions on an attorney under FRCP Rule 11 and Bankruptcy Rule 9011, the Bankruptcy Court will consider: (1) whether reasonable inquiry into facts was made; (2) whether reasonable inquiry into law was made; (3) whether action was taken to harass, delay or increase unnecessarily cost of litigation; and (4) whether the attorney has met his or her continuing obligation to reevaluate the litigation position. *Colvin v. K.W. Well Serv. Inc.,* 78 B.R. 489 (Bankr. N.D. Tex 1987). In *Colvin*, the court imposed sanctions on the trustee's attorney where the trustee's attorney filed a preference action against every receipt of transfer of $10,000 or more without conducting an investigation into merits of claims.

Similarly, *In re Leann Freeman,* 2012 Bankr. LEXIS 6106 (Bankr. E.D. Ca 2012), the trustee took a no-asset case and filed an adversary proceeding against the debtor's parents alleging a fraudulent transfer of a rental property. The adversary proceeding was not filed until 17 days before the bar date, and the trustee did not seriously investigate the facts behind the sale before filing the adversary complaint. *Id.* at 16. Once the debtor's parents responded to the complaint and pled their affirmative defenses, the trustee discovered that the parents had meritorious defenses to the fraudulent transfer claim and that the complaint sought to avoid the wrong transfer. *Id.* By that time, the new claim which the trustee needed to pursue in an amended complaint was time-barred. *Id.* at 17. For violating her duty to investigate the claim before filing the adversary proceeding, the court sanctioned the trustee under Federal Rule of Bankruptcy Procedure 9011.

Although the cases listed above involve trustees filing adversary proceedings, a trustee should also take care to avoid harassment or frivolousness when threatening preference litigation against creditors. For example, is it frivolous for a trustee to send a demand letter to a payee who received funds from a debtor within 90 days of a bankruptcy petition and in the demand letter state that the payee may be liable for trustee attorney fees if the trustee files a preference suit?

**C. <u>546(e) as Limitation on Avoiding Powers against Defendant Banks who were Participants in a Mortgage Loan</u>**

Bankruptcy Code Sections 547, 548(a)(1)(B) and 548(b) grant a bankruptcy trustee broad authority to avoid certain pre-petition transfers made by the debtor. But Section 546(e) creates an exception sometimes available if a transfer is a "margin payment…or settlement payment . . . made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency" or if a transfer is made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency in connection with a securities contract, as defined in Section 741(7)" or certain commodities/clearing-type contracts.

A number of bankruptcy courts, federal district courts, and circuit courts have specifically addressed the definition of "settlement payments". These cases can be divided into two camps: those in which the courts strictly construed the statute and interpreted it to apply to nearly any transaction which involves both a financial institution (or another entity enumerated by the statute) and the payment of funds for securities, and those in which the courts have looked beyond the statutory language and relied on various policy or factual justifications to conclude that Section 546(e) does not per se apply to all payments in connection with transactions within its literal scope.

Much of the case law related to ambiguity or lack thereof in Section 546(e) refers to the definition of "settlement payment." E.g., *In re MacMenamin's Grill Ltd.,* 450 B.R. 414, 418 (Bankr. S.D.N.Y. 2011). *Collier's* and other authorities assert that Section 546(e)'s legislative history reflects the subsection was created "to protect public transactions" that implicate systemic risk to the securities trade. *Collier's on Bankruptcy* ¶ 546.06 [2][b], p. 546-54 (16th ed. 2014); *In re Grafton Partners, L.P.,* 321 B.R. 527, 539 (9th Cir. B.A.P. 2005); *In re Bankest Capital Corp.,* 374 B.R. 333, 346 (Bankr. S.D.Fla. 2007). However, numerous other courts, and *Collier's* itself, hold that Section 546(e) is unambiguous and thus no resort to legislative history is necessary. *Collier's on Bankruptcy* ¶ 546.06[2][b], p. 546-54-55 (16 ed. 2014); *In re Enron Creditors Recovery Corp.,* 651 F. 3d 329 (2d Cir. 2011) (no requirement that transaction implicates systemic risks); *In re Plassein International Corp.,* 590 F. 3d 252 (3rd Cir. 2009), cert. denied, 130 S. Ct. 2389 (2010) (Section 546(e) is not limited to publicly traded securities and also extends to transactions involving privately held securities); *In re Quebecor World (USA) Inc.,* 453 B.R. 201 (Bankr. S.D.N.Y. 2011) (need not consult legislative history about "settlement payment" and nonpublic transactions are included).

This discussion focuses on only one aspect of Section 546(e), whether a participant bank in a mortgage loan participation is protected. If sued under Section 547 or Section 548(a)(1)(B), could a defendant participant bank could argue Section 546(e) is a shield, either because the pertinent payment is "settlement payment" or because the pertinent payment is "in connection with a securities contract, as defined in Section 741(7)"?

Bankruptcy Code Section 741(7) defines "securities contract" to include, among other things, a "contract for the purchase, sale or loan of a security, a certificate of deposit, a mortgage loan, any interest in a mortgage loan, a group or index of securities, certificates of deposit, or mortgage loans or interest therein" and goes on to provide other content. 11 U.S.C. § 741(7)(A)(i). However, Congress in Section 741(7)(B) expressly stated a "securities contract" does not include "any purchase, sale, or repurchase obligation under a participation in a commercial mortgage loan." 11 U.S.C. § 741(7)(B).

Therefore, a participant bank trying to invoke Section 546(e) will tend to need to prove either that the pertinent mortgage loan is not a "commercial" mortgage loan or that the pertinent payment is a "settlement payment" within the definition of 11 U.S.C. 741(8):

"Settlement payment" means a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade."

11 U.S.C. § 741(8). All told, this defense is definitely worth investigating for a participant bank in a mortgage loan that is a mortgage loan for consumer purposes (rather than a "commercial mortgage loan") or a participant bank that became involved in purchasing a "group or index" of consumer mortgage loans. Participant banks in a commercial mortgage loan, however, may be unlikely to qualify as recipient of a "settlement payment" due to Section 741(8)'s focus on "the securities trade."

### D. <u>On-Site Services Provided as Subsequent New Value Defense</u>

In manufacturing or technology contexts in particular, a vendor sometimes provides an on-site consultant or representative to assist the vendee in use of the vendor's product. One question the vendor should raise if faced with a preference action is whether the presence of the consultant or representative at the debtor's facility constitutes "new value."

Section 547(c) provides:

(c) The trustee may not avoid under this section a transfer—

…

(4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor –

(A) not secured by an otherwise avoidable security interest; and

(B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

The term "new value" is defined as "[m]oney or money's worth in goods, services, or new credit…" 11 U.S.C. 547(a)(2). Combining Sections 547(a) and 547 (c), even though a creditor has received a preference, the creditor may still offset any subsequent unsecured credit which was extended to the debtor in the form of goods, services, or new credit. *Jones Truck Lines, Inc. v. Full Serv. Leasing Corp.* 83 F.3d 253 (8th Cir. 1996).

At least one court has analyzed whether the value of a consultant's services provided by a creditor to a debtor constituted new value under Section 547(c). In *Leathers v. Prime Leather Finishes Co.*, 40 B.R. 248 (D. Me 1984), a creditor sought to offset a trustee's preference claim by arguing that the creditor had provided debtor with an on-site technical consultant who provided value to the debtor. The technical consultant testified that he "consistently worked at the debtor's plant, that debtor 'sort of relied upon' his experience and was paid by [the creditor]." *Id*. at 252. The creditor proffered no evidence regarding the actual value of the consultant's services; nor was there any evidence that the services were anything more than incentive gratuity offered to facilitate sales of products. Although the record showed that initially someone at the debtor's plant requested technical assistance with the debtor's products, there was no evidence of an agreement between the parties to pay separately for the consultant's services. *Id*.

The district court agreed that services may be considered new value which may be set off against a previous preferential transfer; however, it held that the consulting services the creditor provided in this instance were not new value distinct from the underlying goods the creditor sold to debtor. *Id*.

Contrast the holding in *Leathers* with that of *Ciesla v. Harney Mgmt. Part.*, 506 B.R. 461 (Bankr. W.D. Tx 2014). In *Ciesla*, a company hired a consultant to advise it as to business operations pre-bankruptcy. The consultant provided uncontroverted evidence that the debtor had hired him to provide consulting services, and that he provided $2,280 in uncompensated services prior to bankruptcy. *Id*. at 481. Although the court concluded that the consultant had received a preference, the consultant was entitled to a $2,280 offset of its extension of new value.

Similarly, in *Sass v. Vector Consulting, Inc*., 476 B.R. 124 (Bankr. D. Del. 2012), a judge concluded that a consulting company had received a pre-petition preference payment. The consulting company argued that it extended new value to the debtor based upon the professional consulting services that an employee provided to the debtor subsequent to the preference payment. The consultant provided uncontroverted evidence that the consulting services totaled $5,440.00. The debtor had approved the consulting services. Based on this evidence, the court concluded that the consultant was entitled to a new value offset totaling $5,440.

In sum, case law suggests that a creditor is entitled to a new value defense for providing consulting services under Section 547(c)(4) in some circumstances. If a creditor is to prevail on such a defense, the creditor must be able to provide evidence indicating the amount of new value the creditor provided, and that the debtor requested, contracted for, or approved the services. Conversely, a creditor faces an uphill battle if it cannot adequately value the consultant's services, or show that the services were a gratuity offered to the debtor in order to facilitate sales of products.

### E. <u>Copyright Perfection and Avoidance Actions</u>

Patents, copyrights, and trademarks are "intangibles" under the Uniform Commercial Code. Unlike other collateral, however, these intangibles are subject to federal law in some important respects. Generally, intangibles are perfected under the UCC by filing a financing statement. UCC 9-302. However, if a federal statute preempts concerning perfection of intellectual property in general or expressly establishes a required federal recording to prevail against a bankruptcy trustee or subsequent purchaser, a federal recordation is often required to defeat a Bankruptcy Code Chapter 5 avoidance action.

Some courts have concluded concerning copyrights that a creditor must file its interest with the U.S. Copyright Office in order to have a properly perfected interest and/or escape avoidance by a bankruptcy trustee. A California district court so concluded when faced with a financing deal where the collateral consisted of a film library involving the "copyrights distributions and rights and licenses of approximately 145 films and accounts receivable arising from the licensing of those films to various programmers." *Nat'l Peregrine, Inc. v. Capitol Fed. Sav. & Loan Ass'n of Denver*, 116 B.R 194 (C.D. Ca 1990). In that case, the bank made UCC filings under state law but did not record its security interest in the Patent and Trademark Office. The court ruled that only registration at the Patent and Trademark office would serve. "The court, therefore, concludes that any state recordation system pertaining to copyrights would be preempted by the Copyright Act." *Id*. at 197. Although no case has specifically overruled *Peregrine*, several cases have called into question its holding. *But see Morgan Creek Prods., Inc. v. Franchise Pictures LLC (In re Franchise Pictures LLC)*, 389 B.R. 131, 142 (Bankr. C.D. Cal. 2008) (citing *Peregrine* with approval).

*Morgan Creek Prods.* involved an "ORAP lien," a device that can help a judgment creditor who is concerned about a judgment debtor's handling of future sales or other proceeds of copyrighted expressions. The *Morgan Creek Prods.* court distinguished a case called *Broadcast Music v. Hirsch*, 104 F.3d 1163 (9th Cir. 1997) and held that the failure to record the ORAP lien with the Copyright Office rendered the lien unperfected.

> While the assignment of future royalties may not be sufficiently related to the underlying copyright to be subject to the Copyright Act, a lien on copyrights or copyright mortgages, as is sought by the ORAP lien, is the type of [**25] encumbrance discussed in *World Auxiliary* and *Peregrine* that the Copyright Act seeks to regulate. One significant purpose of the Copyright Act is to give notice of any transfer of a registered copyright. A "secret" lien such as an ORAP lien is inconsistent with the Copyright Act's purpose. *Hirsch* simply does not involve rights analogous to an ORAP lien. *Hirsch* involved an assignment of royalties for the purpose of satisfying a debt, not an assignment of a security. The rationale for recordation -- "to provide notice to prospective creditors or purchasers of the copyright who may rely to their detriment on the appearance of ownership of the rights under a copyright - is inapposite." *Hirsch,* 104 F. 3d at 1166.
>
> *Morgan Creek Prods*., *supra*, 389 B.R. 131.

The *World Auxiliary* decision referred to above is *In re World Auxiliary Power Co.,* 303 F.3d 1120 (9th Cir. B.A.P. 2002). The 9th Circuit Bankruptcy Appellate Panel held the Copyright Act does not preempt Article 9 for perfection of unregistered copyrights.

*Id. a*t 1128. *World Auxiliary* implies that it is only federally registered copyrights that must be perfected via a Copyright Office recording and that unregistered copyrights are perfected via a UCC financing statement. *Id.* Other authorities imply that unregistered copyrights must first be registered and then the subject of a Copyright Office security interest filing for a creditor to be a perfected secured party.

For an author greatly (and perhaps unusually) in favor of federal preemption, consider Brennan, "Financing Intellectual Property Under Revised Article 9: National and International Conflicts," 23 Hastings Comm. & Ent. L.J. 313 (2001).

Given the age of this case law, what is a leading edge consideration in this area? Consider new tactics concerning product manuals, blueprints, retail-sold software source codes and object codes, or proprietary films. A debtor should consider having the debtor register a copyright in these items with the Copyright Office. The debtor then could argue that a lender's failure to perfect by recording a security interest with that Office renders the lender's interest unperfected and capable of avoidance under Bankruptcy Code Chapter 5.

Also, what if a bankruptcy trustee sells en masse substantially all assets of a large business debtor, including copyrighted software, training or marketing films, blueprints, advertising jingles, or other copyrights? The trustee could insist on segregating some of the bulk asset purchase price for unsecured creditors if the secured lenders do not have both a UCC financing statement and a Copyright Office filing against the copyrighted works.

Moreover, perfection or lack thereof can affect preference litigation against a credit secured party. If the copyright was not perfected and the debtor was insolvent at the time of paying the defendant and of filing bankruptcy, the defendant may have received more than it would have in a Chapter 7. This helps a plaintiff trustee of debtor-in-possession satisfy one statutory requirement of Section 547(b).

### F. Value Threshold for Preference Actions

Section 547(c)(9) prohibits the avoidance of otherwise preferential transfers which have an aggregate value of less than $6,225 in cases where the debtor's debts are not primarily consumer debts. 11 U.S.C. 547(c)(9)**.**

Section 547(c)(9) does not preclude the trustee or the debtor from avoiding a transfer that does not by itself meet the jurisdictional amount if that transfer is one of a series of transfers during the preference period that total at least the statutory amount. For example, in *Young v. Danton* (*In re Transcon. Refrigerated Lines, Inc.)* 438 B.R. 520 (Bankr. M.D. Pa. 2010), the trustee sought to avoid three transfers having the aggregate value of $10,655.93. The defendant sought to dismiss the adversary proceeding as only one individual transfer was in excess of the jurisdictional limit expressed in 11 U.S.C. 547(c)(9). *Id*. at 521. The court held it should "not look to the three individual transfers but rather may aggregate the transfers to meet the monetary floor of *Section* 547(c)(9). *Id*. *See also Western States Glass Corp. of Northern Cal. V. Barris* (*In re Bay Area Glass, Inc.)* 454 B.R. 86 (B.A.P. 9th Cir. 2011).

If the transfer exceeds $6,224.99, then the trustee may recover entire transfer, and not just the excess over $6,224.99. When faced with this question, the 9th Circuit BAP stated, "Read plainly the language of § 547(c)(9) provides a monetary threshold for determining which transfers are avoidable in nonconsumer bankruptcy cases. Put another way, as applied, § 547(c)(9) protects transfers of less than [$6,225] in amount from recovery by a trustee, even though they may otherwise meet the statutory requirements for a preference. By the same token, the statute provides that transfers of [$6,225] or more are entirely avoidable. When Congress intends to limit avoidance to only a portion of a particular transfer, it knows how to do so." *Western States*, at 90.

Finally, "[s]ince the introductory phrase in Section 547(c)(9) limits its application to "a case filed by a debtor" it appears the section does not apply in involuntary cases." 10 *Collier on Bankruptcy* ¶ 547.04[9] (16th ed. 2009). Although this issue has been previously raised, we have found no cases that provide a final determination on the issue. *Schwab v. Peddinghous Corp.* (*In re Excel Storage Products LP)*, 458 B.R. 175 (Bankr. M.D. Pa 2011).

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