8th Circuit Judicial Conference

Fraudulent Transfers and Preferences: Leading Edge Considerations

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Preference Case Update

The following case update focuses on preference decisions within the 8th Circuit region. It excludes U.S. Supreme Court decisions, as the Judicial Conference has a separate speaker on that topic.

Ordinary Course of Business - § 547(c)(2)

Section 547(c)(2): Under BAPCA, no longer are three "ordinaries" required.

Ordinary course of business: "OCB."

Two leading 8th Circuit cases, *Lovett* and, post-BAPCA, *Affiliated Foods.*

Lovett v. St. Johnsbury Trucking, 931 F.2d 494 (8th Cir. 1991)

- Written agreement did not control for determining whether payment was within time that was "ordinary" for the parties' dealings.
- Actual average days between invoice and payment was more salient fact than a seldom-follwed agreement.
- 12-month look-back period appropriate in this case because that was close to the length of the parties' agreement.
- 10-day average speed up in payments did not push such payments outside OCB.
- Creditor insistence that struggling debtor speed up its payments "as much as possible" did not undermine conclusion of OCB.

Cox v. Momar Inc. (In re Affiliated Foods Southwest Inc.), 2014 U.S. App. LEXIS 6571 (8th Cir. 2014)

- Under revised § 547(c)(2), industry standards are no longer a required element.
- 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).
- 8th Circuit looked back 2 years (instead of presumptively following *Lovett*'s 1-year look-back), because there were only 9 transactions in the 2 years before bankruptcy. 1 year would capture only 3 transactions.
- 9-day quicker average payment was not outside OCB.

In re Agriprocessors Inc.

- Background
  - Debtor, Agriprocessors Inc., operated a slaughterhouse and meat-packing factory in Postville, Iowa, that was predominantly known for producing kosher meat.
    - The Rubashkin family founded, owned, and 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.
- Procedural
  - The company declared Chapter 11 bankruptcy after a U.S. Immigrations and Customs Enforcement raid led to numerous criminal charges and financial difficulty.
  - Joseph Sarachek was appointed as Chapter 11 trustee.
  - The trustee filed over 150 adversary complaints against creditors alleging they received preferential transfers.
  - Several adversary proceedings provide insight into recent Northern District of Iowa Bankruptcy Court analysis of 11 U.S.C. § 547(c) defenses.

Sarachek v. Lubicom, LLC., No. 08-2751, 2013 Bankr. LEXIS 1287 (Bankr. N.D. Iowa Mar. 29, 2013)

- 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.

- Genuine issues of material fact remained whether the payments were OCB.

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, charitable corporation. The creditor's rabbi, director, and CEO orally made a short term loan to debtor. There were no written loan documents.
- The transaction followed creditor's pattern (several undocumented loans in the past), but, 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).
  - Debtor had a pattern of borrowing, but engaged in fraudulent activity that could not be in OCB.
- First loan transaction between the parties, creditor could not show the payment occurred in OCB of the parties.
  - Could not determine the industry standards, the loan was undocumented and the terms were unknown.

Sarachek v. Schreiber, No. 08-2751, 2013 WL 1276506 (Bankr. N.D. Iowa March 27, 2013)

- Creditor owned a kosher catering company. Previously, creditor purchased meat from debtor.
- Creditor made two unsecured loans to debtor in the year before bankruptcy.
  - Each loan was memorialized in a promissory note that required debtor to make regular payments on the principal and interest.
- Court found that even if a transaction was truly at arm's length, debts from atypical financing relationships are not protected.
- Even if debtor received loans from other customers – and it could be characterized as part of the OCB for debtor-- 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.

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 checking accounts with creditor bank.
- In the 90 days before bankruptcy, debtor wrote hundreds of checks totaling millions of dollars, for which it had insufficient funds.
- Bank's Procedure
  - Creditor would wait for the debtor to provide funds by cash to cover the overdraft, and then honor the checks.
  - If debtor did not transfer amounts to cover the overdraft before the required deadline, the bank would transfer funds from the debtor's other checking account to cover the overdraft.
- Trustee's Argument
  - Each time a check was presented that resulted in negative funds, the bank was extending credit and the repeated overdrafts constituted a series of short-term loans.
  - When the debtor made a deposit or transfer to cover the overdrafts, the debtor was making a payment on the short term loans.
- Material issues existed as to whether the overdraft agreement was in OCB between the creditor and debtor, and as to what constituted ordinary terms in the industry, particularly for the highly unique terms applicable only to this relationship.

Sarachek v. Goldschmidt, No. 08-2751, 2013 Bankr. LEXIS 4399 (Bankr. N.D. Iowa Oct. 21, 2013)

- Three checks payable to creditor's sole owner and director.
- Court held that creditor provided only four invoices as evidence of the relationship between the parties and none were addressed to debtor.
- Court could not determine the normal billing and payment cycle, or whether the payments met the normal pattern of business between the parties based on limited invoice and payment history.

Subsequent New Value - § 547(c)(4)

Section 547(c)(2) refers to subsequent value "to or for the benefit of the debtor." This may help leading edge defendants with a "laid-in componentry" or "customized though undelivered product" situation discussed after this case update.

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 creditor to support the software on a continuing basis.
- Agreement required debtor to pay a down payment before installation of software and pay a per diem for each day of installation.
- There was no evidence that down payment or per diem was ever paid.
- Creditor's general policy was not to provide any services until down payment was received.
- Court affirmed bankruptcy court's rejection of new value defense, finding creditor's testimony incredible, because creditor supposedly failed to keep copies of records of work or payments involved.

Stoebner v. San Diego Gas & Electric Co. (In re LGI Energy Solutions, Inc.), 746 F.3d 350 (8th Cir. 2014)

- Three-party preferential transfer at issue. Debtor's preferential transfer was made to a defendant (also a creditor) but such transfer benefited debtor's primary creditor.
- Court held that in such three-party situations, new value (whether contemporaneous or subsequent) could come to debtor from the primary creditor.

Facts:

- Debtor LGI served as a conduit between utilities and their customers. Utilities sent customer bills to LGI, and LGI aggregated a customer's various utilities owed. The customers made one payment to LGI for the total. LGI would deposit the payment and then send checks drawn on its account to each utility to pay the customer's invoices.
- Preferential transfer at issue were payments made to LGI to two utilities, on behalf of Buffets and Wendy's restaurants.
- After these payments, the two utilities continued to provide services to restaurants and these services were invoiced. The customers paid LGI for the invoices, but LGI never passed on payment 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 the utility customer creditors because the transfers paid their invoices owed to the utilities.
- Court permitted the utilities to offset all new value the utility customers transferred to LGI subsequent to LGI's preferential payments to the utilities.

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Sarachek v. Schreiber, No. 08-2751, 2013 WL 1276506 (Bankr. N.D. Iowa March 27, 2013) *case also addressed above for OCB

- Creditor lent twice 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.
- Creditor argued that the second loan to the debtor, provided new value and thus should mitigate the amount trustee could recover.
- 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 loan repayments at issue were made after the date of the second loan.

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 sold kosher food products. Creditor's sole shareholder was the second cousin of debtor's President.
- Up to the debtor's bankruptcy, creditor made frequent short-term loans to debtor.
  - Debtor wrote checks from creditor's checkbook as needed and debtor normally paid the loans back within one to three days.
  - The loan agreements were entirely oral. Creditor did not charge debtor interest.
  - Creditor explained that Orthodox Jewish law would not allow creditor to charge interest on the transactions.
- Court held that "each transfer must be examined independently" to determine whether or not the creditor later provided new value.
- 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.
- Factual issues remained whether the debtor *actually* received any new benefit from creditor, or alternatively whether the transfers were paying off old loans.

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.
- Creditor conceded it generally did not make loans to other corporations or individuals, but over 23 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.
- The loans had no schedule for repayment, each transaction was unique in its terms, there were no consistent maturation dates, and loans were paid off intermittently.
- The Court held is was unclear whether the transfer to Cohen after the payments is a repayment of that new value or for older debt.

Contemporaneous Exchange for New Value – § 547(c)(1)

Here, new value is to be "given to the debtor." Section 547(c)(1)(A).

In re Genmar Holdings, Inc., 496 B.R. 532 (B.A.P. 8th Cir. 2013)

- Preferential transfer at issue was a payment to settle an arbitration claim customer brought against the debtor for a defective boat.
- Court emphasized the requirement that the parties intended the exchange to be contemporaneous.
- Settlement agreement requires payment no sooner than 15 days after customer released his lien on the boat.
- Since the parties' intent as evidenced by the settlement agreement was explicitly for payment and release of lien to occur at different times, this was by definition not contemporaneous.

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 with a long term relationship with debtor.
- Over approximately 23 years the creditor made loans to debtor and debtor made payments.
- To prevail on contemporaneous exchange argument, 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.
- 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).

Sarachek v. Luana Savings Bank, 490 B.R. 852, No. 08-2751, 2013 Bankr. LEXIS 1547 (Bankr. N.D. Iowa Apr. 15, 2013). *case also addressed above for OCB

- Debtor maintained at least two separate checking accounts with creditor.
- In the 90 days before bankruptcy, the debtor wrote hundreds of checks totaling millions of dollars, for which it had insufficient funds.
- Bank's Procedure
  - Creditor would wait for the debtor to provide funds by cash to cover the overdraft, and then honor the checks.
  - If debtor did not transfer amounts to cover the overdraft before the required deadline, the bank would transfer funds from the debtor's other checking account to cover the overdraft.
- Creditor argued it provided new value to the debtor by continuing to extend banking privileges and additional check settlements to the debtor.
- 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.

Other Preferences Cases

***In re Big Drive Cattle, L.L.C. v. Overcash*, 2014 U.S. Dist. LEXIS 80853 (D. Neb. June 13, 2014)**

- Creditor had an equity interest in debtor, BDC.
- Creditor bought cattle and had BDC feed and care for them until they reached sale weight, when BDC would sell the cattle for creditor.
- BDC would deposit sale proceeds into its Farm Credit Services account, deduct cost of feed and care, and remit remainder to creditor.
- Bankruptcy Court fund the funds were comingled, and thus payments of the net sale proceeds to creditor was a "transfer of an interest of the debtor" under 11 U.S.C. § 547(b).
- BK court found significant that the FCS account was a revolving line of credit, so all deposits were considered payments on debtor's loan.
- District Court reversed the Bankruptcy Court, finding fact issue exists as to whether funds were held in trust for the creditor, and therefore never became debtor's property.

Lange v. Inova Capital Funding, LLC (In re Qualia Clinical Serv.), 652 F.3d 933 (8th Cir. 2011)

- Creditor entered into a invoice purchase agreement, providing debtor financing by advance payment of debtor's outstanding customer invoices. Debtor gave creditor a security interest in debtor's accounts receivable.
- Creditor filed a UCC-1 financing statement one month before the bankruptcy filing.
- 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).
- Creditor argued it didn't improve its position because it was at all times oversecured.
- Court held that creditor improved its position by perfecting its security interest, because by perfecting its security interest it improved its position 100% as compared to unsecured creditors.

Some Leading Edge Considerations in Preferences and Fraudulent Transfers

- Jury waiver clauses.
- Sanctions for frivolous avoidance actions.
- 11 U.S.C. § 546(e) and defendant banks who were participants in a mortgage loan.
- On-site services/laid-in componentry as new value.
- Copyright perfection.
- Value threshold for preference actions.

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Jury Waivers in Pre-Petition Documents

Trustees sometimes request jury trial in pursuing an avoidance action.

If trustee's action is based on or related to an underlying written contract containing a jury waiver provision, courts have held that the jury waiver is binding on the trustee

Seventh Amendment concerns?

Adelphia Recovery Trust v. Bank of America, 2009 U.S. Dist. LEXIS 63773 (S.D. NY 2009)

Trustee sued banks asserting pre-petition, non-avoidance claims and desired jury.

Loan documents with jury waiver governed relationship between debtor and bank defendants.

Held: loan document jury waivers bound trustee to extent they would have bound debtor.

Kapila v. Bank of America, 493 B.R. 878 (Bankr. M.D. Fl. 2013)

Trustee demanded jury in fraudulent transfer case. Constructive fraud and actual fraud (by debtor, not defendant) alleged.

Fraudulent transfer stemmed from transfers debtor made to bank creditors under applicable loan documents (all containing jury waivers).

Trustee: Suit does not arise under the loan documents.

Court: Trustee cannot exclude himself from documents' jury waiver while asking the court to consider the documents' repayment terms as basis of fraudulent transfer claim.

Sanctions for Frivolous Avoidance Actions

- Some courts cracking down on frivolous avoidance actions. *See Maxwell v. KPMG, LLP*, 520 F.3d 713 (7th Cir. 2008).
  - Trustee of defunct entities lacks some inhibitions about lawsuits that going concerns do.

- Frivolous or harassing for trustee to send demand letter to payee who received funds within preference period and state that payee may be liable for attorney fees if trustee files preference suit?

546(e) Limitation on Avoiding Powers

546(e) creates an exception if a transfer is made by or to a financial institution in connection with certain securities contracts.

"Securities contract" includes mortgage loans, but not a purchase, sale, or repurchase obligation under a participation in a commercial mortgage loan.

Section may well apply to participant bank who purchased a consumer mortgage loan or group/index of such loans.

On-Site Services as New Value Under § 547(c)

Manufacturing and technology vendors often provide on-site representatives to help integrate products into vendee's operation.

Can vendor assert a "new value" defense for providing the representative?

On-Site Services as New Value Under § 547(c) (ctd.)

- Court will analyze the relationship between debtor and creditor.
- *Leathers v. Prime Leather Finishes Co.*, 40 B.R. 248 (D. Me 1984): The consulting services that creditor provided were not new value distinct from the underlying goods creditor sold to debtor.
- *Ciesla v. Harney Mgmt. Part.*, 506 B.R. 461 (Bankr. W.D. Tx 2014): The consulting services creditor provided was new value because creditor could show the value of the services provided as well as debtor's approval of such services.

Copyright Perfection and Avoidance Actions

- Copyrights are “intangibles” under the UCC but are also subject to federal law.
- UCC – Perfect security interest in intangibles by filing UCC Financing Statement.
- Federal law allows creditors to note interests in intellectual property by filing at the U.S. Copyright Office.
- What happens if creditor files in only one location?

Nat'l Peregrine, Inc. v. Capitol Fed Sav. & Loan Ass'n, 116 B.R. 194 (C.D. Ca 1990)

- Creditor had security interest involving copyrights .
- Bank made UCC filings under state law but did not record security interest in the U.S. Copyright Office.
- Court ruled that only recording at the U.S. Copyright Office would serve, and concluded that any state recordation system pertaining to copyrights would be preempted by Copyright Act.

Copyrights not federally registered

Split of authority as to how to perfect a security interest.

In re World Auxiliary Power Co., 303 F.3d 1120 (9th Cir. B.A.P. 2002): Copyright Act does not preempt Article 9 for perfection of unregistered copyrights. 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.

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.

Copyright tactics

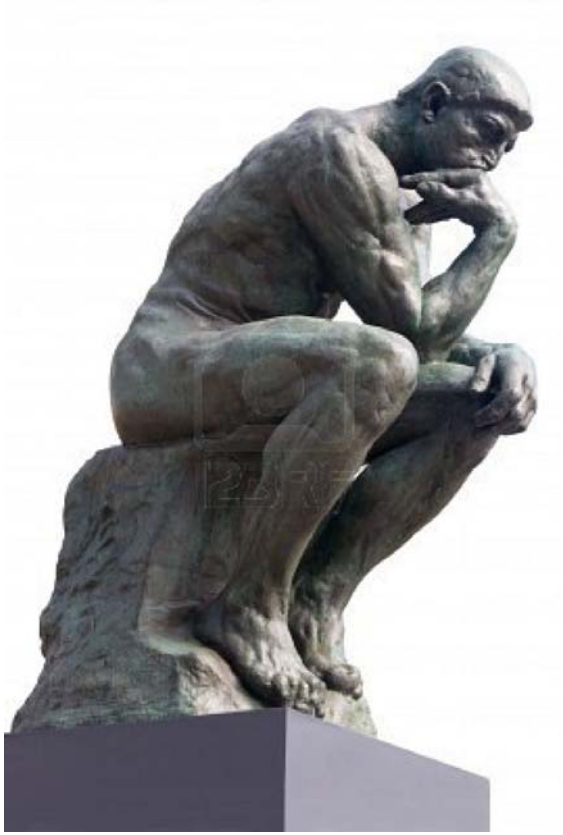
Creditor: Secured creditor could file in both offices (Copyright Office and pertinent Secretary of State under UCC) if not already done. Count days for preference exposure. If unsecured judgment creditor, consider seeking a creditor's bill giving power to federally register copyrightable writings/media of a judgment debtor, thus creating a potential lack of perfection in any security interest?

Debtor: If seeking financing or other capital raising, consider tactic #2 above? If creditor already liquidated "collateral," see if it received a preference because it sold assets within 90 days of bankruptcy that weren't encumbered by perfected lien.

Value Threshold for Preference Actions

- Section 547(c)(9) prohibits the avoidance of preferential transfers less than $6,225.
- Can aggregate transfers' value if transfer is one of a series of transfers during preference period that total statutory amount.
- If transfer exceeds $6,224.99, trustee may recover entire transfer, not just excess over $6,225.

Questions



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