Assignment 31
The Bankruptcy Trustee’s Power
to Avoid Fraudulent and/or
Preferential Transfers

Reference: Understanding Secured
Transactions § 16.04[E]

Trustee Avoiding Powers

• The bankruptcy trustee has the power to
avoid the following transfers of the debtor’s
property that occurred prior to bankruptcy
  – Unperfected security interests (strong-arm
  power) [§ 544(a)]
  – Fraudulent transfers [§ 548(a)]
  – Preferential transfers [§ 547(b)]

Fraudulent Transfers

• At common law, creditors have always had the
ability to set aside transfers by a debtor that
were intended to hinder, delay, or defraud
creditors
  – E.g., Rita is suing Tom for negligence
  – To avoid losing his home to Rita, Tom gives deed
to his home to his brother Ted (who lets Tom to
continue to live there)
  – After Rita gets a judgment, she can have court
invalidate Tom’s deed as fraudulent transfer, and
then have the land sold to satisfy her judgment lien

§ 548(a)(1): Fraudulent Transfers

• Bankruptcy trustee can avoid (set aside) any
transfer by the debtor that occurred within two
(2) years prior to bankruptcy, if the transfer was
  – (a) Intentionally fraudulent as to creditors, or
  – (b) Constructively fraudulent as to creditors
• Transfer is constructively fraudulent (even if not
intentionally so) if:
  – (a) debtor received less than reasonably equivalent
value in exchange for the property, and
  – (b) debtor was insolvent at time of transfer, or was
rendered insolvent by the transfer:
Hypo

• Debtor borrows $200,000 from Bank
  – Debtor grants SI in equipment worth $500,000
  – Bank perfects SI by filing UCC-1
• Six months later, Debtor’s business fails, and Debtor files Ch. 7 bankruptcy petition
• Trustee sues Bank to invalidate its SI as a fraudulent transfer

Which Statement Is Correct?

A. Ch. 7 Trustee can set aside Bank’s SI as a constructively fraudulent transfer
B. Ch. 7 Trustee cannot set aside Bank’s SI as a constructively fraudulent transfer

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Hypo 2

- Debtor owes Bank $200,000; Bank has SI in equipment (worth $500,000)
- After default, Bank conducts Article 9 foreclosure sale, at which Bank buys equipment for $200,000 credit bid
- Six months later, Debtor files Ch. 7 petition
- Trustee then sues Bank to invalidate foreclosure sale as a constructively fraudulent transfer

As Judge, would you …

A. Uphold the foreclosure sale as valid if the sale was commercially unreasonable under Article 9
B. Set aside the foreclosure sale as a constructively fraudulent transfer, even if the sale was commercially reasonable

- At first blush, § 548(a)(1)(B) appears to allow trustee to set aside the foreclosure
  - Sale was within 2-year “reachback” period
  - Sale was for $200K (collateral worth $500K), which does not seem “reasonably equivalent” value
- Thus, if debtor was insolvent at time of sale, or was rendered insolvent by sale, it seems Trustee should be able to set aside the sale
  - Rationale: surplus value of collateral has been “hijacked” by Bank, to detriment of other creditors

- U.S. Supreme Court has held that if a foreclosure sale was regularly conducted and not collusive, the foreclosure sale price is deemed “reasonably equivalent value” for the collateral sold [In re BFP (1994)]
- Thus, if a foreclosure sale is commercially reasonable, Trustee cannot later set it aside as a constructively fraudulent transfer under § 548(a)
- Is this a sensible interpretation?
Preferences

- Suppose Debtor has $100 of assets, but owes $100 to A, $100 to B
  - Debtor is insolvent (liabilities >> assets)
  - Debtor pays A in full, pays B nothing (A is “preferred”)
- Outside of bankruptcy, state law gives no remedy to B
  - It presumes A and B can each protect its own interests

Preference Avoiding Power

- Bankruptcy Code [§ 547] allows trustee (or debtor in possession in a Chapter 11 case) to set aside certain preferential pre-bankruptcy transfers
  - Rationale: preserves integrity of bankruptcy process and statutory scheme of bankruptcy distribution
  - Prevents creditors from successfully making a “last minute grab” of a debtor’s assets, to detriment of other similarly situated creditors

Elements of a Preference

- (1) Transfer of property of the debtor [§ 547(b)]
- (2) To/for benefit of a creditor [§ 547(b)(1)]
- (3) On account of antecedent debt [§ 547(b)(2)]
- (4) Made while debtor insolvent [§ 547(b)(3)]
- (5) Made w/in 90 days prior to bankruptcy filing (or w/in 1 year, if creditor was an “insider”) [§ 547(b)(4)]
- (6) Creditor better off than if it had been paid only in a Chapter 7 liquidation proceeding [§ 547(b)(5)]

Two Kinds of Possible Preferences

- Debtor pays $$ to Creditor in payment of a debt during preference period
- Debtor transfers Creditor a security interest during the preference period
  - Granting of a SI is a “transfer” of an interest in the debtor’s property (the collateral)
Problem 31.1(a)

• Wooden Indus. filed bankruptcy on Sept. 1
• On August 15, Wooden had borrowed $300K from Firstbank
  – August 15: Firstbank took SI in equipment
  – August 16: Firstbank filed proper UCC-1
• Trustee for Wooden seeks to avoid Firstbank’s SI as a preference

Problem 31.1(a): Can Wooden Industries’ Bankruptcy trustee avoid Firstbank’s SI in the equipment as a preference?

A. Yes, the SI was a preferential transfer
B. No, the SI was not a preferential transfer

Problem 31.1(b)

• Feb. 7: Wooden borrowed $300K from Secondbank
• Aug. 11: Wooden granted Secondbank a SI in equipment, Secondbank filed proper UCC-1
• Sept. 1: Wooden files for bankruptcy
• Trustee sues to avoid Secondbank’s SI in the equipment as a preference
Problem 31.1(b): Can Wooden Industries’ Bankruptcy trustee avoid Secondbank’s SI in the equipment as a preference?

A. Yes
B. No

Secondbank’s SI is an avoidable preference (“last minute grab” at debtor’s property):
- If Wooden hadn’t granted SI, Secondbank would’ve been unsecured
- As unsecured creditor, it would have received only a pro rata distribution on its entire claim
- With a SI in the collateral, Secondbank gets 100% payment on its claim, to the extent of the value of the collateral
- Secondbank is thus better off than it would’ve been as an unsecured creditor in Ch. 7 liquidation

Problem 31.1(c): Can Wooden Industries’ Bankruptcy trustee avoid Thirdbank’s SI in the equipment as a preference?

A. Yes
B. No

Feb. 7: Wooden borrowed $300K from Thirdbank, which took SI in certain equipment
Aug. 11: Thirdbank filed proper UCC-1 (postal error)
Sept. 1: Wooden files for bankruptcy
Trustee sues to avoid Thirdbank’s SI in the equipment as a preference
§ 547(e) “Timing” Rules

- SI is “perfected” for purposes of § 547 when judicial lien creditor can’t acquire a superior interest [§ 547(e)(1)(A)]
  - Perfected under Art. 9 = perfected under § 547(e)
- Transfer of SI is deemed “made”:
  - Upon attachment, if SI is perfected w/in 30 days [§ 547(e)(2)(A)]
  - Upon perfection, if perfected >> 30 days later [§ 547(e)(2)(B)]
  - At petition date, if not perfected at that date [§ 547(e)(2)(C)]

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Delayed Perfection

- Rationale for § 547(e)(2) timing rule?
  - Lack of filing creates ostensible ownership problem for creditors dealing with debtor (unaware of Thirdbank’s SI, due to lack of UCC-1 filing)
  - Thus, concern really isn’t that Thirdbank is being preferred, but that delayed perfection created potential for constructive fraud on third parties
  - § 547 makes this a “preference” in order to deal most effectively w/the “secret lien” problem

§ 547 and After-Acquired Property

- 2012: Bank took SI in all of Debtor’s equipment (including after-acquired)
- Aug. 15, 2013: Debtor buys a new machine (FMV = $20,000)
- Sept. 1, 2013: Debtor files for bankruptcy
  - On petition date, Debtor owes Bank $200,000
  - On petition date, FMV of collateral (including the new machine) = $200,000
- Trustee argues: Bank’s SI in the new machine is a preference
Has the Bank received a preferential transfer?

A. No (security agreement was entered > 90 days prior to bankruptcy)
B. No (new machine didn’t improve Bank’s position)
C. Yes

§ 547 and After-Acquired Property

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  – On petition date, Debtor owes Bank $200,000
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• Trustee argues: Bank’s SI in the new machine is a preference

Is Bank’s security interest in the new machine a preference?

A. Yes
B. No
In this situation, Bank’s SI in the new machine is NOT received a preference
– SI in new machine is deemed to have been granted on August 15, when Debtor acquired the machine [§ 547(e)(3)]
– Thus, SI is deemed granted on account of antecedent debt, w/in 90 day preference period
– But, Bank was fully secured anyway, and thus would’ve already gotten full payment in a Chapter 7 liquidation case (Bank not made better off)
• Trustee can’t avoid Bank’s SI in new machine

Problem 31.1(f)
• March 9: Wooden couldn’t meet payroll, so it borrowed $300,000 from Elsa Cohen (wife of Wooden’s CEO) (loan intended to be secured)
• April 12: Wooden finally signs agreement granting SI to Elsa Cohen, who filed UCC-1
• Sept. 1: Wooden files bankruptcy petition
• Trustee: Elsa’s SI in the collateral is an avoidable preferential transfer

Is Elsa Cohen’s security interest in the collateral a preference?
A. Yes
B. Maybe
C. No, it wasn’t on account of an antecedent debt
D. No, it was outside the 90-day “preference” period

Insiders and The Preference Period
• General 90 day preference period [§ 547(b)(4)(A)] is extended to 1 year if transfer is made to a creditor that is an “insider” [§ 547(b)(4)(B)]
  – “Insider” would include spouse of corporate officer (such as Elsa Cohen) [§ 101(31)(b)]
  – Rationale: “insiders” could manipulate filing date to insulate transfers to themselves
Insolvency [§ 547(b)(3)]

- If debtor isn’t insolvent at time of transfer, transfer isn’t a preference (b/c there are still enough assets to pay all other creditors)
  - “Insolvent” [§ 101(32)] = liabilities >>> assets
- Debtor is presumed insolvent during 90 days prior to petition date [§ 547(f)]
  - Burden on recipient of transfer to prove that debtor was solvent at time transfer occurred

Debtor is presumed insolvent during 90 days prior to petition date [§ 547(f)]
- Burden on recipient of transfer to prove that debtor was solvent at time transfer occurred

- Trustee must essentially create “balance sheet” for Wooden as of April 12

Problem 31.1(f)

- In this problem, however, Trustee is not entitled to presumption of insolvency (petition was filed >> 90 days ago) [§ 547(f)]
- To avoid Elsa’s SI as a preference, Trustee must prove Wooden was insolvent on Apr. 12, when transfer occurred
  - Trustee must essentially create “balance sheet” for Wooden as of April 12

Problem 31.3

- Two years ago: Swissbank took and perfected a floating lien in Debtor’s inventory
- June 1: Debtor owes Swissbank $2.5 million (inventory value = $1.2 million)
- August 29: Debtor files bankruptcy
  - On petition date: Debtor owes Swissbank $1.5MM
  - On petition date: Inventory value = $700K (all of the inventory was acquired by Debtor after June 1)

Problem 31.3: The “Problem”

- B/c SI in “after-acquired” inventory doesn’t arise until Debtor acquires it, § 547(e)(3) timing rule threatens “floating lien” security interests
  - SI in current on-hand inventory (all “after-acquired”) is deemed by § 547(e)(3) to have been granted on account of an antecedent debt!
  - The SI in each new item of inventory improved Swissbank’s position as compared to Chapter 7 distribution
Floating Liens in Bankruptcy

• Practical problem: If D’s inventory “turns over” every 90 days (or faster), then § 547(b) could wipe out Swissbank’s entire floating lien
• But, use of a floating lien is not by itself strategic behavior or “last minute grab” by Swissbank
  – D is constantly buying new inventory, but D is also typically borrowing/repaying on its inventory line of credit, too

• Trustee can only avoid floating lien on D’s inventory or accounts to the extent that the acquisition of the new collateral and payments improved creditor’s position during 90-day preference period [§ 547(c)(5)]
• “Two point net improvement” test
  – Swissbank’s secured position on petition date?
  – Swissbank’s secured position 90 days prior?
  – Trustee can avoid SI to the extent of improvement

Swissbank’s position 90 days prior: $1.2MM (inventory) - $2.5MM (debt) = [$1.3MM]
• Its position at petition date: $700K (inventory) - $1.5MM (debt) = [$800K]
• Net improvement is $500K, so Trustee can avoid Swissbank’s SI in $500K worth of the inventory
  – $500K of assets that otherwise would’ve paid unsecured creditors have improved Swissbank’s position during 90 days prior to bankruptcy
• Thus, Swissbank’s claim is: $200K secured claim, $1.3MM unsecured claim

Preference Exception: § 547(c)(1)

• A transfer that would otherwise be an avoidable preference under § 547(b) cannot be avoided if the transfer:
  – Was intended to be a contemporaneous exchange for new value given to the debtor, and
  – Was in fact substantially contemporaneous
• Rationale: not preferential in actual effect
§ 547(c)(1) Example

- Friday afternoon: Bank wires money to Debtor in Chicago to purchase art, and Debtor agrees to sign security agreement upon returning to St. Louis on Monday
- Monday morning: Debtor goes to Bank and signs security agreement, Bank files UCC-1

Preference Exception: § 547(c)(3)

- A SI that would otherwise be an avoidable preference under § 547(b) cannot be avoided if it:
  - Secures new value given by secured party at or after signing of security agreement
  - Secures new value given to enable debtor to acquire the collateral (and actually used for that purpose)
  - Is perfected on or before 30 days after debtor takes possession of the collateral
- PMSI/enabling loan not preferential in its effect

§ 547(c)(3) Example

- July 1: Bank loans Debtor $20,000 to buy a machine, Debtor signs security agreement, Bank files UCC-1
- July 15: Debtor actually buys the machine
  - SI attached when Debtor bought the machine, so SI is on account of an antecedent debt!
  - But under § 547(c)(3), this PMSI cannot be set aside by the trustee