Avoiding Avoidance Actions in Bankruptcy

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For most non-bankruptcy attorneys, their first experience in bankruptcy court could very likely begin with a call from an agitated and bewildered client asking for help to understand why they have been sued by a trustee in a bankruptcy case filed by one of its customers. Even worse, the client's incredulity may only be exacerbated by the fact this same customer still owes your client money! This is when a basic working knowledge of avoidance actions in bankruptcy cases would be extremely helpful.

For bankruptcy trustees and Chapter 11 debtors-in-possession (and for purposes of this article we will only refer to trustees as the terms in this context are interchangeable) an important aspect of any bankruptcy case—indeed a chief source of recovery for any bankruptcy estate—is the availability to the trustee of avoidance actions. These are legal actions to recover money or property that was transferred by the debtor before the bankruptcy case was filed. There are several types of avoidance actions that are covered by the Bankruptcy Code that can be pursued by a trustee. The most common of these are preferences and fraudulent transfers. In this article we will provide a top-level summary of the legal standards for recovering on avoidance actions, and the defenses and strategies available to companies or individuals that are the unfortunate targets of such litigation.

Section 547 of the Bankruptcy Code permits a trustee to recover, or claw back, a preference, which is generally a payment made by the debtor to any party within 90 days of the bankruptcy filing that was made on account of an existing debt. These actions target creditors who were paid, partially or in full, prior to the commencement of the bankruptcy.

While the look-back period for preference actions is 90 days for most creditors, that period is extended to one year for any creditor who is considered an "insider" of the debtor. In the case of an individual debtor, insiders include a relative of the debtor or a partnership or corporation in which the debtor is an owner, partner, director or officer. Where the debtor is a corporate entity, insiders normally include owners, directors, officers or persons deemed to be in control of the debtor. The Bankruptcy Code defines "relative" as an "individual related by affinity or consanguinity within the third degree as determined by the common law." This also includes step or adoptive relationships.

The goal behind preference actions it to level the playing field so that one creditor is not paid in preference to another. Understandably, many preference defendants feel they are being unfairly targeted and find it hard to get past the reality that they have done absolutely nothing wrong. It is important to note that in a preference action, there is no implication of wrongdoing. Rather, the aim is to return all creditors to the same position they would have been in had the payment not been made.

There are three commonly asserted defenses to a preference action. Significantly, the only available defenses are those provided under Section 547(c) of the Bankruptcy Code.

First, a defendant may argue that a transfer was not on account of an existing debt but rather a contemporaneous exchange for new value. The most common illustrations of this type of transaction are store purchases, or good shipped COD. The payment is not considered a preference since it is not made to satisfy a pre-existing debt.
Also, a "new value" defense may be available to the preference defendant, where, after receiving the allegedly preferential payment, the creditor provided additional services and/or product to the debtor for which the creditor was not paid. This new value defense can serve to offset the defendant's exposure, or in some cases completely shield a defendant from liability if the new value exceeds the amount of the challenged transfers. For example, if your client receives a "preferential" payment from a debtor in the amount of $1,000, then subsequently ships goods to the debtor valued at $800 for which no payment is received, your client's preference exposure is limited to $200.

Finally, an important and often used defense to a preference is commonly referred to as the ordinary course defense—where a payment was made in the ordinary course of business and financial affairs of the debtor and the transferee. In order to successfully argue the ordinary course defense, your preference defendant will need to show either that the challenged payments were made according to the parties' business terms, or that the payment history between the parties has been consistent both prior to and during the 90-day preference period. For example, where your client's invoice specifies that payment is due in 30 days, then payments made within 30 days are completely defensible. On the other hand, if your client can establish that, notwithstanding 30-day terms, payments were made consistently between, for example, 45 and 60 days throughout the business relationship with the debtor, then this is also a defensible position.

So what to do if your client is faced with a preference claim? First, consider trying to resolve the matter quickly. Know that about 99% of all preference cases settle before trial. However, to achieve a favorable result, have your client to gather its transactional history with the debtor going back at least a year and more, if available. This will help determine whether one of the statutory defenses is available to your client and can be helpful in determining the strength of your negotiation position.

A second common avoidance action is a fraudulent transfer, which is set out in Section 548 of the Bankruptcy Code. The language of Section 548 closely mirrors New Jersey state law, and the New Jersey Uniform Fraudulent Transfers Act (UFTA).

To succeed under Section 548, a trustee must establish that the debtor either: (a) made a transfer with the actual intent to hinder, delay or defraud a creditor; or (b) received less than equivalent value or the transfer, and the debtor was either insolvent at the time of the transfer, became insolvent as a result, incurred or intended to incur debts which it would not be able to repay, or made the transfer for the benefit of an insider.

Because a debtor will seldom, if ever, admit to transferring property with the actual intent to defraud its creditors, actual fraud will often be proven through circumstantial evidence. Courts in New Jersey consider several factors in determining whether a debtor acted with fraudulent intent. Some of these factors are the relationship of the debtor to the recipient, whether the debtor maintains possession of the property that was transferred, whether the transfer was concealed from its creditors, whether the transfer constituted substantially all of the debtor's assets, and whether the debtor was sued or threatened with suit prior to the transfer. All factors do not need to be proven for a court to find fraudulent intent.

In most cases, however, a trustee will attempt to establish that a fraudulent transfer was not with actual intent, but rather constructively fraudulent as a result of the circumstances. For example, commonly avoidable fraudulent transfers in the case of an individual debtor include pre-petition transfers from a debtor to his spouse or children for nominal consideration. In the corporate context, trustees commonly seek to recover payments made by the corporate debtor on behalf of its owners and officers. For example, does the officer have a corporate credit card that is used for non-business purchases, but for which the company pays the bill?

While the Bankruptcy Code specifically provides for a fraudulent transfer look-back period of two years, a trustee may avail himself of the longer, four-year look-back period allowed under the New Jersey UFTA.

The best defense to a fraudulent transfer claim is that reasonably equivalent value was given in exchange for the property transferred. In determining whether the consideration was reasonably equivalent, courts will engage in a two-step process to evaluate the totality of the circumstances. First, did the debtor receive value? Transferring the deed to a property for one dollar, or paying for your company treasurer's vacation does not constitute value. However, if value is received, was it "reasonably" equivalent? Looking at the circumstances surrounding the transfer, was the value received by the transferee reasonably equal to the value given by the debtor? Yes, the debtor paid the company treasurer's credit card bill, but the charges on the credit card were all business related.

Fraudulent transfers can and do occur, inadvertently and quite frequently, especially with small or family-run businesses. It is important to be on the look-out for some common scenarios in which they occur, and to counsel clients accordingly. Spotting these issues allows for corrective measures to be taken. For example, minimize exposure to your company treasurer by having him reimburse the company for any credit card use that is personal in nature. Also, where the client operates more than one entity, and one of the entities routinely pays the debts of another due to cash flow issues, encourage a reconciliation of such payments when cash is available. Finally, it is obviously a better preventative measure to discourage an insolvent client from transferring property to a relative simply to keep it out of the reach of creditors.

Regardless of whether your client has been sued for a preference or a fraudulent transfer in a bankruptcy case, it is indeed advisable to consult a bankruptcy professional who may offer experienced counsel to minimize your client's liability.

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ATTORNEYS MENTIONED

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