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Chapter 11 - "101"

Overview of Avoidance Actions

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Editor's Note: *This is the seventh installment of Chapter 11-"101," a monthly column intended to instruct readers in the nuts and bolts of chapter 11 practice. Consider obtaining and reading the six prior installments if you have not already done so, as each installment builds on the background built in prior installments.*

The way to understand a chapter 11 debtor's avoiding powers is to recognize that it wears two hats. For the first hat, think the Lone Ranger, or at least Burl Ives in *East of Eden*. He's the stranger who comes in on the game and scoops all the money off the table to distribute it in an equitable manner.

For the second hat, think Hagar the Horrible, with helmet and horns. Under this hat, he is the representative of creditors and can do things that the debtor cannot do.

To grasp this point, recall the history of bankruptcy law: In the beginning, bankruptcy was a kind of proto-class-action, where creditors clubbed together to collect their debts. They selected the trustee; he was, in a sense, their agent. It is not surprising, therefore, that he could do things they could do. Specifically, he gets to set aside, unravel, treat as a nullity—or in the jargon of bankruptcy law, "avoid"—certain transactions that the debtor engaged in before bankruptcy.

The bite is that these transactions are often perfectly valid between debtor and transferee. But they won't be binding on creditors—and the trustee (in his Hagar headgear) is the creditors' voice.

The Supreme Court got this point interestingly wrong in a case decided nearly a century or so ago, just after the beginning of our modern bankruptcy law. The case is *York Manufacturing Co. v. Cassell*, 201 S.Ct. 344 (1906). A creditor held a conditional sales contract that was valid against the debtor, but was not filed in the public records and so was invalid against creditors. The Supreme Court held that the trustee stepped into the shoes of the debtor and took the property of the debtor subject to any encumbrances that would have been binding on the debtor.

The Court thus got the Lone Ranger point, but missed the Hagar point altogether. Congress responded quickly with amendments giving the trustee the powers of a lien creditor and a judgment creditor. The legislative history made it clear that Congress intended to overrule *York*, but in a broader sense, you might say it was merely reestablishing the traditional view that the trustee (or DIP, acting as trustee) has powers, exercisable for the benefit of creditors, that go beyond those rights that the pre-petition debtor would have.

In our current Bankruptcy Code, we have half a dozen or more "avoiding powers," most of which are the progeny of this overruling amendment. Each of these avoiding powers is codified in chapter 5 of the Bankruptcy Code (and are thus sometimes referred to as "chapter 5 causes of actions"). Explaining the various avoiding powers is easiest by illustration.

Hypothetical Lien Creditor and BFP Rights

Start with the most intelligible case. Fredco borrows $10 million from Barney Bank and gives it a security interest in its Dinobarn, hitherto owned by Fredco free and clear.

In addition to the security agreement signed by Fredco granting Barney Bank a security interest in Dinobarn, it also signs a financing statement. However, Barney Bank forgets to file the financing statement in the public records. Another creditor, Gazoo Corp., who does not hold a security interest, gets a judgment against Fredco and sends the sheriff out to levy on Dinobarn. As between Barney Bank and Gazoo Corp., who wins?

The answer is Gazoo Corp. The Uniform Commercial Code says (with Byzantine indirectness) that an unperfected security interest is subordinate to the rights of a lien creditor. On levy, Gazoo Corp. becomes a lien creditor. Barney Bank's financing statement remains unfiled, therefore unperfected, so Gazoo Corp. prevails.

So much for state law. What of bankruptcy? The answer is in §544(a)(1), which provides that the trustee has the rights of a lien creditor. Fredco goes into bankruptcy owing Barney Bank, Gazoo Corp. and others: Barney Bank has a security interest, but unfiled; Gazoo Corp. has a claim, but not a lien. If Gazoo Corp. had got a lien at state law before Barney Bank filed, then Barney Bank's security interest would have been subordinate to Gazoo Corp.'s claim.

So, per §544(a)(1), Barney Bank's security interest is subordinate to the rights of the trustee. Barney Bank retains its claim, but loses its security interest; it has to go to the back of the queue and share with the other unsecured creditors (including Gazoo Corp.), *pro rata*.

Actually, the provision is even more powerful than we have seen so far. Based on what we have seen, we can say that the trustee "steps into the shoes" of Gazoo Corp. But the section provides that the trustee gets this right "whether or not such a creditor exists." In other words, if a creditor *could have* trumped Barney Bank on the petition date, then the trustee can trump Barney Bank. As a practical matter, this may not seem to amount to much: At least in our example, there virtually always will be a creditor with the right to trump Barney Bank. But the practical point is that the trustee doesn't have to prove it; he can operate on the rule of "as if."

So far, this sounds like "classic bankruptcy"—trustee as a kind of "class representative" doing what a creditor could do. But go back and tweak our first example. Suppose that Fredco gave Barney Bank a security interest in not Dinobarn, but in Blackacre, a parcel of real estate. Note that the Uniform Commercial Code (UCC) no longer governs. We are in the realm of real estate law. Suppose as before that Fredco signs, but that Barney Bank neglects to record, a mortgage. Fredco does not pay. As between Barney Bank and Gazoo Corp., who gets first dibs on Blackacre?

You might think that the answer would be the same as before, and in some states, indeed it is. But in many states, real estate priority rules differ from the rules under the UCC. Many states say that the unrecorded mortgage is void against "a bona fide purchaser," or words to that effect. However, quite a few cases hold that a "lien creditor" is not a "bona fide purchaser." So if Gazoo Corp. is a (mere) lien creditor, it may lose the priority conflict with an unrecorded mortgage—even though it would win it against an unperfected security agreement in personal property.

This rule may or may not make sense, but that is beside the point. The point—in bankruptcy—is this: If Fredco goes into bankruptcy and the trustee had nothing but the "lien creditor" power of §544(a)(1), then Barney Bank's mortgage retains its priority, even though unrecorded. Another avoiding power, however, provides that the trustee has the rights of "a bona fide purchaser," and thus the trustee can avoid the unrecorded mortgage on real property just as he can set aside the unperfected security interest in personal property.

Fraudulent Transfers

Under non-bankruptcy fraudulent transfer law, a creditor may avoid a transaction between the debtor and a third party if the transaction is, on appropriate standards, adverse to the creditor. Bankruptcy law "annexes" fraudulent transfer laws in two interesting ways.

First, §544(b) provides that the trustee may avoid a transfer that is "voidable by a creditor" at state law. This rule is both broader and narrower than the rule under §544(a), which we examined above. It is broader in that it grants rights to "creditors" without qualification—not just to the narrower class of "lien creditors," as in §544(a). It is narrower in that, to use the power, the trustee (or DIP) has to prove the existence of an actual creditor by whom the transfer might have been avoidable. This is not trivial: If the trustee fails to prove the existence of such a creditor, he loses. There are plenty of cases where the trustee has identified what looks like a promising fraudulent-transfer avoidance action, only to lose it because he can't make the link to an actual creditor offended at state law.

Second, §548 is a fraudulent-transfer provision in its own right, giving the trustee the authority to avoid fraudulent transfers without having to rely on §544(b)'s incorporation of state law. Under §548(a)(1)(A), the trustee may avoid a transfer that was made with the *actual intent* to "hinder, delay or defraud" a creditor—call it an "actual fraud" fraudulent transfer. Under §548(a)(1)(B), the trustee may avoid a transfer made for "less than a reasonably equivalent value." If he is relying on this "constructive fraud" premise, then he must also show one of three additional facts. That is (somewhat simplified), he must show that the debtor was either:

- insolvent at the time of the transfer, or rendered insolvent thereby;
- engaged in a business or transaction for which his remaining property was "unreasonably small capital;" or
- intending to incur debts beyond his capacity to repay.

The critical distinction here is the matter of *intent.* If the trustee can show the relevant intent, then he doesn't have to worry about issues of solvency or value. If he has the right evidence on value and solvency, he doesn't have to worry about intent.

Section 548 parallels and in many respects duplicates state law as codified via the Uniform Fraudulent Transfer Act. So the question arises, given §548, is there any reason for §544(b)? The answer is "yes." There are at least two reasons.

One, §544(b) may pick up some fraudulent transfers that §548 misses. For example, under §548, the trustee can reach back to undo transactions made only within a year before bankruptcy. The state law reach-back period is longer—typically three to five years. Two, §544(b) gives the trustee the power to avoid *any* transaction that is voidable under state law—*i.e.*, not just fraudulent transfer laws. State law may present opportunities for avoidance aside from fraudulent transfer law. For example, a few states retain so-called "bulk-transfer" statutes, permitting an aggrieved creditor to avoid bulk transfers of inventory. In the appropriate case, this right, too, will pass to the trustee.

Preferences

All the rights we have examined so far are predicated more or less on non-bankruptcy law. There is one important avoidance power that exists independently of non-bankruptcy law. This is the power to avoid preferences under §547.[1]

To understand preferences, you must understand what they are not. Consider the case of Delbert, who owes $100 each to Butcher, Baker and Candlestick Maker, all unsecured. Delbert pays $100 in cash to Butcher and then files for bankruptcy, holding no other assets. Baker and Candlestick Maker have claims against the estate of Delbert, but the claims are worthless. Butcher has no claim because he was paid in full. The first thing to note about this case is that Delbert's conduct is not "wrong" in any global sense, because it is not wrong to pay a debt.

The trouble is that a first principle of bankruptcy law is that similarly situated creditors share *pro rata*. If you allow the debtor to pick and choose which creditors it pays on the eve of bankruptcy, then you undercut this first principle. So it is not surprising to find in the Bankruptcy Code a rule that allows the trustee to undo certain pre-bankruptcy transactions, otherwise unobjectionable, that would have the effect of undercutting the principle of *pro rata* distribution.

The core of preference law is in §547. The *prima facie* case is in §547(b). It provides (slightly simplified):

The trustee may avoid a transfer
- to a creditor
- for an antecedent debt (a debt that existed before the transfer)
- made while the debtor was insolvent
- and within 90 days before bankruptcy (or one year if the recipient is an insider)
- if it permits the creditor to get more than it would get in chapter 7.

So in our example, Delbert is clearly insolvent: he has $100 and owes $300. If the transfer had not occurred, then creditors would have taken (1/3)($100) = $33.33 each (ignoring costs), so Butcher clearly got more via the transaction than he would have under chapter 7. The only open question is timing: If the transaction was made within 90 days before bankruptcy, then it would appear to be avoidable. If it was made earlier—say, 91 days before bankruptcy—then it would seem to be bulletproof.

Most preferences involve payment of money to satisfy a debt, but there is one other case that is important but perhaps not so obvious—*i.e.*, suppose that Delbert, rather than paying Butcher, merely gave him a security interest in all his property to secure his antecedent debt, and that Butcher perfected that security interest within 90 days of bankruptcy. Assuming the other conditions are met, then this giving of

1 But note that some states have their own preference laws.

security may also be a preference and avoidable under §547.

The *prima facie* elements of a preference are not, however, the end of the story. There are many cases where the debtor made a payment that meets the elements of a preference, but will not be avoidable because it falls within one of the defenses set forth in §547(c).

The most common of these is probably the "ordinary course of business" defense, which exempts from preference recovery payments made in the ordinary course of business between the debtor and the recipient and on customary terms. A second common defense is "subsequent new value" which exempts a payment from avoidance to the extent that, after receiving the payment, the recipient gives some additional value (say, ships new goods) to the debtor. This defense essentially allows the creditor to offset the value it gave to the debtor after receiving a preferential payment against its preference liability.

There are many other defenses, and one of the first tasks of a lawyer defending a preference action is to go through the list in §547(c) to see which defenses might apply. ■

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