What's Your Preference? Selected Issues in Avoidance Actions

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Introduction

The year 2008 has been described as "the year the financial system stopped working."[2] The bailouts of Frannie Mae and Freddie Mac, the bankruptcy of Lehman Brothers, the dissolution of Bear Stearns, the near-failure of a number of other financial institutions, and other catastrophic events involving some of the nation's largest companies catalyzed massive financial losses in the markets. As a result of this financial distress, the bankruptcy courts have played a large role in shaping how companies and financial institutions are reorganized and, in certain cases, liquidated. There has been a consequential renewed interest in preference and avoidance actions, in which trustees and debtors-in-possession (hereinafter referred to solely as "debtor" for convenience) attempt to recover certain prepetition transfers for the benefit of the bankruptcy estate.

I. 546(e)'s Safe Harbor for Securities Settlement Payments

Section 546(e)[3], often referred to as a "safe harbor" provision, limits the power of trustees to recover certain commodity and securities transaction payments that would otherwise be avoidable under the Bankruptcy Code. It provides that a trustee may not avoid a transfer that is a "settlement payment" or a "margin payment" which has been made by, to, or for the benefit of a "commodity broker," a "forward contract merchant," a "stockbroker," a "financial institution," a "financial participant," or a "securities clearing agency" before the commencement of a bankruptcy case, as such terms are defined in sections 101, 741, and 761 of the Bankruptcy Code.[4] Such payments may be made by the various entities listed in

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1 The authors acknowledge the invaluable assistance of their colleagues Elisha D. Graff and Terry Sanders in the drafting of this article.

2 Floyd Norris, *A Year of Chaos in Finance*, N.Y. TIMES, Dec. 18, 2008, at B1.

3 11 U.S.C. § 546(e) (2006).

4 Section 546(e) states: "Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, 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 that is a transfer 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), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title." 11 U.S.C. § 546(e).

section 546(e) to a third party, or by a third party to one of the entities listed within section 546(e). As a result of amendments made by the Financial Netting Improvements Act of 2006,[5] section 546(e) is also applicable when a transfer is made by, to, or for the benefit of one of these entities in connection with: (1) a "securities contract" as defined in section 741(7); (2) a "commodity contract," as defined in section 761(4); or (3) a "forward contract," as defined in section 101(25).

While section 546(e) does not apply to "actual fraud" cases under section 548(a)(1)(A) of the Bankruptcy Code,[6] section 546(e) does limit other avoidance action powers including those set forth in: (1) section 544 (the trustee's strong arm power to, among other things, prime unperfected liens); (2) section 545 (the trustee's power to avoid certain statutory liens); (3) section 547 (the trustee's power to avoid preferential transfers); (4) section 548(a)(1)(B) (the trustee's power to avoid constructively fraudulent transfers and obligations made or incurred based on constructive fraud); and (5) section 548(b) (the trustee's power to avoid transfers made or obligations incurred to a general partner).[7]

Section 546(e) has been used with increasing frequency as a defense to avoidance actions that arise out of securities purchase transactions, including fraudulent transfer actions. It promotes an objective that is more deeply rooted in securities law than in bankruptcy law – that is to limit actions that could disrupt the market for buying and selling securities. When it is successfully asserted as a defense to an avoidance action, the bankruptcy estate is arguably harmed while the securities market is presumably preserved. As the Second Circuit recently commented, 546(e) consequently "stands at the intersection of two important national legislative polices on a collision course – the policies of bankruptcy and securities law."[8]

[5] Financial Netting Improvements Act of 2006, Pub. L. No. 109-390, § 5(b)(1), 120 Stat. 2692. This statute is effective as to cases commenced on or after December 12, 2006.

[6] Under Section 548(a)(1)(A), a trustee may avoid transfers made, or obligations otherwise incurred, with the actual intent to hinder, delay, or defraud creditors. 11 U.S.C. § 548(a)(1)(A). Section 546(e) explicitly states that the exemptions that it contains do not apply to transfers and payments made under Section 548(a)(1)(A): "the trustee may not avoid a transfer [that falls under certain categories under this statute] . . . *except under [S]ection 548(1)(1)(A) of this title*." 11 U.S.C. § 546(e) (emphasis added).

[7] 11 U.S.C. § 546 (2006).

[8] *In re Enron Creditors Recovery Corp.*, 651 F.3d 329, 336-37 (2d Cir. 2011) (quotations omitted).

A. A Brief History of the Interpretation and Application of Section 546(e)

Section 546(e) was initially enacted by Congress in the early 1980s[9] with the goal of "minimiz[ing] the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries."[10] As Professor Samir D. Parikh of the Northwestern School of Law of Lewis & Clark College explains, the initial policy rationale underlying the enactment of 546(e) lies in the very nature of the purchase of publicly held stock, which "involves anonymous players and a number of intermediaries that make various guarantees that add certainty to a process that is not instantaneous."[11] Because "the system depends upon the availability of these guarantees to a clearing agency," the "bankruptcy of any one of the participants in the chain poses a threat to the rest of the parties in the chain and, conceivably, the market as a whole."[12]

The manner in which section 546(e) has been interpreted and applied since its codification – as well as the broad application that many courts give it today – in many ways parallels the changing face of the American economy and financial world. For example, when 546(e) was codified in the early 1980s, acquisitions through leveraged buyouts occurred only infrequently. There was "not one mention of leveraged buyouts or the potential fraudulent transfer implications of stock transfers pursuant to a leveraged buyout in the 500 pages of testimony" from the 1981 Subcommittee Hearings in which section 546(e) was debated.[13] As Professor Parikh points out, between 1970 and 1984, when 546(e) was put into law as part of the 1984 Bankruptcy Act, only roughly 100 LBOs had occurred in total.[14] In contrast, between 1985 and 1999, more than 2,700 LBOs occurred, a percentage of which ended up in debt defaults and bankruptcies. In this period, courts began to frequently apply fraudulent transfer law to LBO-related

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9 The safe harbor provisions of section 546(e) were first enacted in 1978 as Section 764(c) of the Bankruptcy Code. In this iteration, they only protected transfers made in the ordinary course of business in the commodities market, and, accordingly, applied exclusively to margin payments made in connection with commodities clearing organizations. *See, e.g.,* H.R. REP. NO. 97-420, at 581 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583. In 1982, Congress amended the safe harbor provisions, replacing Section 746(c) with Sections 546(e), 741(5), and 741(8). This amendment took place in order "to clarify and, in some instances, broaden the commodities market protections and expressly extend similar protections to the securities market." *Id*.

10 H.R. REP. NO. 97-420, at 1 (1982), *reprinted in* 1982 U.S.C.C.A.N 583, 583.

11 Samir D. Parikh, *Saving Fraudulent Transfer Law* 4 (unpublished manuscript), electronic copy available at: http://ssrn.com/abstract=1927418 (last visited Jan. 14, 2012) (providing extensive discussion and commentary) [hereinafter Parikh].

12 *See id*.

13 *Id.* at 29.

14 *See id*.

bankruptcies, which in turn led shareholders, both private and public, to turn to the section 546(e) safe harbor, relying on the plain language of the statute and the fact that it does not distinguish between privately and publicly held shares.[15] While courts initially rejected the statute's application to privately held securities – citing 546(e)'s legislative history which they felt clearly indicated that it had been enacted to protect the public securities markets – many courts have since backed away from this approach.

Indeed, commentators and scholars have noted that the judicial attitude toward a broader application of section 546(e) began to shift in the 1990s, with rulings including *In re Kaiser Steel Corp.* and *In re Resorts International.* In 1991, the Tenth Circuit in *In re Kaiser Steel Corp.* stated that "on its face [section 546(e)] is clear …. Certainly, we cannot say that the clear application [of 546(e) to LBO-related preference actions] is absurd, given the fact that disruption in the securities industry – an inevitable result if leveraged buyouts can freely be unwound years after they occurred – is also a harm the statute was designed to avoid."[16] Accordingly, the Tenth Circuit affirmed that LBO-related transfers qualified as settlement payments made to stockbrokers, and, as such, were exempt under section 546(e). Similarly, in 1999 the Third Circuit in *In re Resorts International* held that the plain language of section 546(e) is clear, and that nowhere within the statute is there any provision for a distinction between publicly and privately held shares, nor is there any carve-out for LBO-related transfers.[17] Finding that the language of 546(e) was clear and, moreover, that its application to privately-held LBO-related shares would not bring about an absurd consequence, the Third Circuit applied 546(e) to such actions[18] in an opinion that had an enormous impact on other courts.

While there continues to be a split among the Circuits and district courts regarding the application of section 546(e), the current trend is to apply an expansive reading of the statute that favors the non-avoidability of these securities-related transfers. The Second, Third, Sixth, Eighth and Tenth Circuits have held that a broad interpretation of section 546(e) is appropriate and applies to both publicly held and privately held securities.[19] In fact, an increasing number of courts have held in recent years that so long

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15 *See id*.

16 *In re Kaiser Steel Corp.*, 952 F.2d 1230, 1240-41 (10th Cir. 1991) (citing *Kaiser Steel Corp. v. Charles Schwab & Co., Inc.*, 913 F.2d 846, 848-49 (10th Cir. 1990)).

17 *In re Resorts Int'l, Inc.*, 181 F.3d 505, 515-16 (3d Cir. 1999).

18 *Id.* at 515-16.

19 *See, e.g.*, *In re Resorts Int'l, Inc.*, 181 F.3d at 516; *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 986 (8th Cir. 2009); *In re QSI Holdings*, 571 F.3d 545, 550 (6th Cir. 2009); *In re Plassein Int'l Corp.*, 590 F.3d 252, 257-58 (3d Cir. 2009); *In re Enron Creditors Recovery Corp.*, 651 F.3d at 334-35; *see also In re MacMenamin's Grill Ltd.*, 450 B.R. 414, 420 (Bankr. S.D.N.Y. 2011); Parikh at 39.

as a securities transaction may be considered "common" and not irregular or illegal, any payment made pursuant to it is by definition a "settlement payment" under section 741(8) – regardless of whether it takes place in the public markets. For example, in the recent Second Circuit case of *Enron Creditors Recovery Corp.*, the court found that the phrase "commonly used in the securities trade" – contained within section 741(8) – was intended to function as a catch-all expression which in turn served to underscore the very breadth of section 546(e).[20] The Eighth Circuit reached a similar conclusion in *Contemporary Industries Corp. v. Frost*, as have many other courts.[21] Section 741(8) itself gives what has often been described as a somewhat tautological definition of a "securities payment," defining it as "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, … or any other similar payment commonly used in the securities trade." Bankruptcy treatises and case law have noted that this includes "transfers which are normally regarded as part of the settlement process, whether they occur on the trade date, the scheduled settlement day, or any other date in the settlement process for the particular type of transaction at hand."[22]

B. The Current Trend toward a Broad Interpretation of 546(e) and the Remaining Split Among the Circuits

1. A Current and Continuing Trend toward Broad Application

The current trend among Circuit courts is decisively toward a broad interpretation of section 546(e). In 2009 alone, the Courts of Appeals for the Eighth, Sixth, and Third Circuits – in *Contemporary Industries Corp. v. Frost*, *In re QSI Holdings*, and *In re Plassein Intern. Corp.*, respectively – confirmed or adopted liberal readings and applications of section 546(e) and held that, regardless of whether a company is publicly traded or privately held, certain payments made through financial institutions in connection with LBOs are protected by section 546(e). In short, "[a]ll three appellate courts rejected the argument that a payment could not qualify as a 'settlement payment' if it was not made as part of a so-called 'ordinary course' securities transaction."[23] In *Contemporary Industries Corp. v. Frost*, the Eighth Circuit affirmed that payments made to shareholders of a privately held corporation in exchange for their

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20 *In re Enron Creditors Recovery Corp.*, 651 F.3d at 335-39; *see also, e.g.*, *In re Enron Creditors Recovery Corp.*, 422 B.R. 423, 433-34 (S.D.N.Y. 2009).

21 *Contemporary Indus. Corp.*, 564 F.3d at 986; *see also In re Resorts Int'l*, 181 F.3d at 515-16; *In re Comark*, 971 F.2d 322, 326 (9th Cir. 1992); *In re Kaiser Steel Corp.*, 952 F.2d at 1237-40; *Kaiser Steel Corp.*, 913 F.2d at 848-51.

22 11 U.S.C. § 741(8) (2006); *see also* Alan N. Resnick & Henry J. Sommer, COLLIER ON BANKRUPTCY § 5-546, 546.06[2][b], 546.06[2][b] n.34 (6th ed. 2011 [hereinafter COLLIER ON BANKRUPTCY] (quoting *In re Comark*, 971 F.2d 322, 325 (9th Cir. 1992)).

23 *In re Enron Creditors Recovery Corp.*, 422 B.R. at 430.

shares in connection with an LBO constituted settlement payments under section 546(e) and, as such, were exempt from avoidance actions.[24] Relying upon decisions from other circuits which had held that section 741(8) is "extremely broad and intended to encompass most payments that can be considered settlement payments,"[25] the Eighth Circuit concluded that the statutory text had a clear and unambiguous meaning and that its application did not lead to an absurd result.

Less than three months after an opinion was issued in *Contemporary Industries*, the Sixth Circuit considered for the first time whether section 546(e) may be applied to privately traded securities and LBO-related transfers in *In re QSI Holdings, Inc*.[26] Citing *Contemporary Industries*, the Sixth Circuit held that privately held securities fell within the statutory definition of a "settlement payment."[27] Addressing arguments that such a ruling was contrary to the policy concerns underlying the statute's initial enactment, the court stated that the "value of the privately held securities at issue is substantial and [therefore] there is no reason to think that unwinding" the settlement in question "would have any less of an impact on financial markets than publicly traded securities."[28] The Sixth Circuit also held that the activities of an exchange agent bank affirmatively constituted transfers "made by or to" a "financial institution," agreeing with the Third and Eighth Circuits that a financial institution need not have a "beneficial interest" for section 546(e) to apply.[29] While some have suggested that "it may be argued that the Sixth Circuit's decision does not expand the application of [section] 546(e) as broadly as the Eighth Circuit, and is limited to private companies with a substantial number of shareholders,"[30] this decision is nonetheless significant. Additionally in 2009, the Third Circuit in *In re Plassein International Corp.* pointed to the direct authority of *In re Resorts International* and reaffirmed that section 546(e) applies to privately traded and LBO-related securities.[31]

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24 *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 at 986.

25 *Contemporary Indus. Corp.*, 564 F.3d at 985 (citing *In re Resorts Int'l, Inc.*, 181 F.3d 505, 514-15 (3d Cir. 1999); *In re Comark*, 971 F.2d 322, 326 (9th Cir. 1992); *Kaiser Steel Corp. v. Charles Schwab & Co., Inc.*, 913 F.2d 846, 848 (10th Cir. 1990)).

26 *In re QSI Holdings*, 571 F.3d 545, 547 (6th Cir. 2009).

27 *Id.*

28 *Id.* at 550.

29 *Id.* at 550-51.

30 George V. Utlik & Schuyler G. Carroll, *The Safe Harbor Provided for 'Settlement Payments' by Section 546(e)*, 19 NORTON J. BANKR. L. & PRAC. 3 Art. 8, 321, 331 n.109 (2010) (quotations omitted).

31 *In re Plassein Int'l Corp.*, 590 F.3d at 257-58.

Also in 2009, the Southern District of New York held in *In re Enron Creditors* that the premature redemption of a debt security, along with any other payment that had been "made in the securities trade to consummate securities transactions," constitutes a security transaction to which the safe harbor of 546(e) applies,[32] given that section 741(8) does not limit the definition of a settlement payment to those payments that are commonly used in the securities trade.[33] Examining the existing case law regarding the application of section 546(e) to private securities transactions, the *Enron* court concluded that "there is no policy reason to depart from what appears to this Court to be the plain meaning of the literal language of the Bankruptcy Code."[34] The Second Circuit agreed with the Southern District's holding and analysis in the summer of 2011[35] in an opinion that has already had a major impact on several important bankruptcy and district court rulings, including those pertaining to Madoff Ponzi scheme-related fraudulent transfer actions.[36]

2. The Minority View: In re Munford and Its Progeny

Among the Circuits, only the Eleventh Circuit Court of Appeals has ruled – in *In re Munford, Inc.* – that section 546(e) has a significantly more limited scope. In its ruling, the Eleventh Circuit concluded that in order for a transaction to fall within the safe harbor of section 546(e), the transaction must involve a formal clearance and settlement process and involve a publicly traded security. The *Munford* court also held that securities transactions involving "mere intermediary" financial institutions or stockbrokers without beneficial interests in a transferred asset were not intended to be covered by section 546(e). This decision, however, is almost two decades old and has been criticized for creating a requirement that does not exist in the language of the statute.[37] Nonetheless, the Eleventh Circuit decision in *Munford* has been followed by select district courts and bankruptcy courts.

Other courts have explicitly refused to apply section 546(e) to a private stock transfer due in part to their interpretation of the term "settlement payment" as it appears in the Bankruptcy Code. Interestingly, these courts have argued that this definition is limited by the phrase that appears at the end of section 741(8) – "or any other similar payment commonly used in securities trade" – the same term that

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32 *In re Enron Creditors Recovery Corp.*, 422 B.R. at 442.

33 *Id*. at 429-34.

34 *Id.* at 441.

35 *In re Enron Creditors Recovery Corp.*, 651 F.3d at 330.

36 *See Picard v. Katz*, No. 11 Civ. 3605(JSR), 2011 WL 4448638 (S.D.N.Y. Sept. 27, 2011).

37 *In re Munford Inc.*, 98 F.3d 604, 609-610 (11th Cir. 1996); *see also In re MacMenamin's Grill Ltd.*, 450 B.R. at 420 n.7 (contrasting the Eleventh Circuit's approach with authority on the breadth of Section 546(e)); *see generally* Parikh (providing commentary).

other courts, including the Second and Eighth Circuits – have read as underscoring 546(e)'s breadth. For example, in *In re Norstan Apparel Shops, Inc.*, an Eastern District of New York Bankruptcy Court case decided roughly four years before the Second Circuit issued its decision in *Enron*, the court held that because private stock sales conducted in connection with an LBO are not "commonly used in the securities trade," they are not covered by section 546(e).[38]

Munford its progeny implicitly subscribe to the theory that a trustee's avoidance of non-public securities transactions will not cause disruption of the securities system.[39] For example, in the 2005 case of *Buckley v. Goldman, Sachs & Co.*, the District Court of Massachusetts remarked that what Congress had sought to accomplish in its enactment of section 546(e) "was to protect the operation of the security industry's clearance and settlement system"[40] – an interest that the court did not find would be "furthered in any meaningful sense by bringing an LBO like the one at issue in [the *Buckley*] case under the exemption of [section] 546(e) simply because funds fortuitously passed through financial institutions on their way into the hands of the defendants."[41]

3. Looking toward the Future

The United States Supreme Court has yet to resolve this Circuit split. However, the current trend among the majority of the Circuits appears firmly in favor of interpreting the statute's defense broadly and, despite the minority "narrow" approach in certain jurisdictions, the current trend for a broad reading is likely to continue. It is noteworthy that both the Third and Second Circuits have now explicitly endorsed a broad application of the protections of section 546(e). In addition, the fact that Congress sought to broaden, rather than narrow, section 546(e)'s scope in the 2006 Financial Netting Improvements Act seems to support this approach.[42] Given the current economic environment and increasing frequency

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38 *In re Norstan Apparel Shops, Inc.*, 367 B.R. 68, 75-77 (Bankr. E.D.N.Y. 2007) (quotations omitted).

39 *See* Parikh (providing commentary on point).

40 *Buckley v. Goldman, Sachs & Co.*, No. Civ. A02-CV-11497RGS, 2005 WL 1206865, at *7 (D. Mass. May 20, 2005).

41 *See id.*

42 The relevant 2006 Financial Netting Improvement Act amendment was explicitly intended to "help reduce systemic risk in the financial markets by clarifying the exemption's application to transactions functionally similar to those already covered by the prior version of [S]ection 546(e)." *In re MacMenamin's Grill Ltd.*, 450 B.R. at 420 (internal citations omitted) (citing H.R. REP. NO. 109-648, pt. 1, at 1 (2006)). As Congress stated, the "common thread of these transactions is that they involve financial intermediaries – stockbrokers, financial institutions, financial participants or securities clearing agencies – that often hedge their risk on these transactions through other market transactions, repledge securities collateral received under these transactions, or both. As such these transactions implicate the systemic risk concerns that are addressed by the safe harbors." *Id*. (citing H.R. REP. NO. 109-648, pt. 1, at 4 (2006)).

of avoidance actions in bankruptcies, the question of how section 546(e) ought to be interpreted has perhaps never been so important.

II. Ordinary Course of Business After BAPCPA

Under section 547(b) of the Bankruptcy Code, a trustee may avoid, as preferential transfers, certain prepetition transfers or incurrences of obligations that were made within specified time periods before a debtor's bankruptcy. In theory, this recovery power discourages creditors from "racing to the courthouse to dismember a debtor"[43] during the debtor's slide into bankruptcy, instead allowing the debtor to work its way out of its financial difficulties.[44] Preference actions also promote one of the overarching goals of bankruptcy law: equality of distribution between a debtor's similarly situated creditors.[45] Accordingly, a creditor that has received a preferential transfer can be required to return a transfer in order to allow all similarly situated creditors to share in the debtor's assets equally.

Section 547(c)(2) of the Bankruptcy Code – the so-called "ordinary course of business" defense to preference actions – is one of nine distinct statutory affirmative defenses that a creditor may assert to defeat a preference claim.[46] Under this defense, a trustee cannot avoid a transfer made or an obligation incurred in the ordinary course of business between debtor and creditor. The primary purpose of section 547(c)(2) is to encourage creditors to engage in customary and normal transactions with a debtor and to limit preference recoveries to those transfers that arise from unusual and prejudicial debt collection practices. In other words, section 547(c)(2) seeks "to leave undisturbed normal financial relations because it does not detract from the general policy of the section to discourage unusual action by either the debtor or its creditors during the debtor's slide into bankruptcy."[47]

A. BAPCPA's Changes to the Ordinary Course of Business Defense

It is well established that the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), which amended section 547(c)(2), provides "ordinary course of business" defendants with greater protection against preference claims.[48] Prior to the BAPCPA, section 547(c)(2) stated that a

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43 *Union Bank v. Wolas*, 502 U.S. 151, 152 (1991).

44 The ordinary course of business defense must be proven by a preponderance of the evidence. COLLIER ON BANKRUPTCY at § 5-547, 547.01 (6th ed. 2011).

45 *Union Bank v. Wolas*, 502 U.S. at 151-52.

46 S. REP. NO. 95-989, at 78 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5874; *see also Advo-Sys., Inc. v. Maxway Corp.*, 37 F.3d 1044, 1047 (4th Cir. 1995).

47 S. REP. NO. 95-989, at 78 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5874.

48 To the extent that a creditor is sued for an allegedly preferential transfer in a bankruptcy case that was filed before BAPCPA's effective date, October 17, 2005, the prior version of Section 547(c)(2) controls. *See, e.g.*, *In re SGSM Acquisition Co.,* 439 F.3d 233, 237 n.1 (5th Cir. 2006).

preference action defendant could escape liability to the extent that it could establish that a transfer was: (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee; (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; ***and*** (C) made according to ordinary business terms. Many courts construed this provision to require a defendant to establish not only that the debt and payment were made in the ordinary course of business between the debtor and the transferee, but also that the transfer was typical within the relevant industry.

In contrast, the post-BAPCPA version of the statute provides that a preference action defendant may escape liability to the extent that it can establish that the transfer in question 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 that such transfer was (A) made in the ordinary course of business or financial affairs of the debtor and transferee; ***or*** (B) made according to ordinary business terms. Accordingly, rather than showing that the transaction in question is *both* ordinary between the parties *and* according to ordinary business terms within the industry, a creditor now need *only show one or the other*.[49] The Ninth Circuit has observed that the result of this change can be extreme – specifically, even "*first-time transfers* can come within the exception if they meet the 'ordinary business terms' requirement, measured by industry practice, even if there is no course of business between the parties."[50]

In many other ways, however, it may be too early to tell exactly how, or in what ways, case law and defense strategies concerning the ordinary course of business defense have been altered post-BAPCPA. As commentators and practitioners have remarked, "[t]here are few reported decisions applying revised section 547(c)(2), which makes it difficult to assess the practical impact of the

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49 As the Fifth Circuit commented in 2006, "[u]nder the BAPCPA, the second and third prongs of the ordinary course defense have become disjunctive rather than … conjunctive." *In re SGSM Acquisition Co.*, 439 F.3d at 240 n.4. Consequently under the revised statute, creditors are protected from a trustee's attempts at recovery if challenged transfers may be shown to have been in the ordinary course of the creditors' dealings with the debtor – regardless of whether this type of transfer was common in the relevant industry. Furthermore, creditors are protected from a trustee's attempted recovery action if they are able to adequately demonstrate that the transfers in question were made according to ordinary business terms, whether or not they were made in the ordinary course of business dealings between creditors and the debtor. See *In re Nat'l Gas Distribs.*, 346 B.R. 394, 396, 402 (Bankr. E.D.N.C. 2006) (stating: (1) that the objective standard could be invoked by a creditor even in instances where a course of dealing existed between the parties and the transfers at issue clearly deviated from that course of conduct; and (2) that the "ordinary business terms" defense is now a distinct, independent defense.); *see also* Richard Levin & Alesia Ranney-Marinelli, *The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L. J. 603, 637 (2005).

50 *In re Ahaza Sys. Inc.*, 482 F.3d 1118, 1123 n.4 (9th Cir. 2007) (emphasis added).

amendments to date."[51] This is in part because "[a]n overwhelming majority of preference claims are settled prior to trial … and although it is reasonable to assume that the changes have enhanced defendants' settlement leverage, it would be difficult to verify this empirically."[52] However, a few issues that have appeared in post-BAPCPA case law are particularly notable. These issues include (1) questions concerning the applicability of pre-BAPCPA case law; and (2) questions concerning what industry standard ought to be applied in making 547(c)(2)(B) determinations.

1. Questions Concerning the Applicability of Pre-BAPCPA Case Law

Although the operative terms in section 547(c)(2) are not defined in the Bankruptcy Code, there is ample pre-BAPCPA case law interpreting such terms. Consequently, and because the actual language used in each prong of section 547(c)(2) did not change, many litigants have argued that pre-BAPCPA case law still controls post-BAPCPA preference litigation.[53] Indeed, Collier on Bankruptcy states that the "case law regarding the 'ordinary course of business' has been well developed for some time," and that "[t]hese cases survive the enactment of the 2005 amendments, since the language of each prong of the defense remains unchanged."[54] Other case law and commentary, however, has suggested that pre-BAPCPA case law may have only limited applicability. Accordingly, the extent to which pre-BAPCPA case law still controls remains an unresolved question.

In *In re National Gas Distributors*, the first case to examine section 547(c)(2) post-BAPCPA, the Eastern District of North Carolina Bankruptcy Court held that the BAPCPA had altered the statute, affecting the applicability of "pre-BAPCPA case law construing" aspects of it, namely 547(c)(2)(B).[55] This holding, however, was expressly rejected in 2011 by the Bankruptcy Court for the Eastern District of Michigan in *In re American Camshaft Specialties, Inc.* In *American Camshaft*, the court rejected the trustee's argument that, under *National Gas Distributors*, the objective test under section 547(c)(2)(B) had changed post-BAPCPA and, that therefore, "pre-BAPCPA cases construing 'ordinary business terms'

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51 Kiah T. Ford IV, *'Ordinary Course Of Business,' Extraordinary Times*, LAW360 (Feb. 26, 2009), http://www.parkerpoe.com/media/pnc/9/media.379.pdf.

52 *See id*. *NB*, given sufficient data, it might be possible to verify this assumption through an examination of settlements pre- and post-BAPCPA to see whether the relatively more lax statutory requirement has been priced into such settlements.

53 *See, e.g.*, *In re Horob Livestock Inc.*, 382 B.R. 459, 486-87 (Bankr. D. Mont. 2007) (stating that pre-BAPCPA case law is instructive in interpreting the post-BAPCPA objective standard of Section 547(c)(2)(B), and looking to pre-BAPCPA precedent.); *In re Am. Camshaft Specialties, Inc.*, 444 B.R. 347, 363 (Bankr. E.D. Mich. 2011) ; COLLIER ON BANKRUPTCY at § 5-547, 547.04 (6th ed. 2011).

54 COLLIER ON BANKRUPTCY at § 5-547, 547.04 (6th ed. 2011).

55 *In re Nat'l Gas Distribs.*, 346 B.R. at 403 (citing COLLIER ON BANKRUPTCY at § 547.04 547-58 (6th ed. 2011); and *Advo-Sys., Inc. v. Maxway Corp.*, 37 F.3d at 1051-52.

are 'less instructive.'"[56] The court further noted that "although revisiting the ordinary business terms standard might be warranted in other circuits where controlling precedent is unclear," the controlling Court of Appeals had already "articulated a clear and consistent standard, from which" the bankruptcy court saw "no reason to deviate."[57]

2. Questions Concerning What Industry to Consider for 547(c)(2)(B)

Many questions that arise out of post-BAPCPA case law concerning the section 547(c)(2) ordinary course of business defense are focused upon the "ordinary business terms" prong of the defense, which is contained in section 547(c)(2)(B). These decisions have focused upon what industry should be considered in determining the "ordinariness" of the business terms involved in an allegedly preferential transfer. While pre-BAPCPA case law did address this issue, a very early post-BAPCPA case cast the question in a different light given the amendments made to the statute.

The first element of the section 547(c)(2) defense – contained in section 547(c)(2)(A) – requires the court to examine the debt for which the alleged preferential transfer served as payment, and "the normality of such incurrences in each party's business operations generally."[58] While there is relatively little case law that specifically addresses this issue, courts are generally satisfied if a defendant demonstrates that a debt was incurred in the routine operation of the debtor and creditor – for example, in a non-remarkable arms-length commercial transaction that occurred in the open marketplace rather than an irregular and tacit insider agreement.[59]

To determine whether a defendant has satisfied section 547(c)(2)(A) – whether the transfer is consistent with the parties' course of dealing – "the court must engage in a subjective 'peculiarly factual' analysis."[60] Primarily, the court must determine whether transactions conducted before and during the applicable preference period were consistent.[61] For this reason, transfers that might be found to be

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56 *In re Am. Camshaft Specialties, Inc.*, 444 B.R. at 363 (citing *In re Nat'l Gas Distribs.*, 346 B.R. at 404).

57 *Id*. at 364.

58 *In re Youthland*, 160 B.R. 311, 314 (Bankr. S.D. Ohio 1993).

59 *See, e.g.*, *In re Valley Steel Corp.*, 182 B.R. 728, 735 (Bankr. W.D. Va. 1995); *see also In re Youthland*, 160 B.R. at 314-15.

60 *In re Fulghum Constr. Corp.*, 872 F.2d 739, 743 (6th Cir. 1989) (citing *In re First Software Corp.*, 81 B.R. 211, 213 (Bankr. D. Mass. 1988)); *see also In re Globe Mfg. Corp.*, 567 F.3d 1291. 1298 (11th Cir. 2009) (ordinary course inquiry is subjective); *Lovett v. St. Johnsbury Trucking*, 931 F.2d 494, 497 (8th Cir. 1991).

61 Section 547(b)(4) states that a transfer will be preferential under section 547 only if the transfer is made "on or within 90 days before the date of the filing" of the debtor's bankruptcy petition, or between 90 days "and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider." 11 U.S.C. § 547(b)(4)(A) and (B) (2006).

generally irregular on other grounds may ultimately be found to be "ordinary" for the purpose of 547(c)(2)(A) if they were consistent with the "baseline of dealing" that had taken place between the parties before the debtor was in financial difficulty.[62] In order to determine if a payment is ordinary for this purpose, courts have considered several factors. Four of the most common factors are: (1) the length of time the parties were engaged in the transaction at issue; (2) whether the amount or form of tender differed from past practices; (3) whether the debtor or creditor engaged in any unusual collection or payment practices; and (4) the circumstances under which the payment was made.[63] Notably, otherwise ordinary transfers which were the result of "unusual debt collection or payment practices" are not protected under section 547(c)(2)(A).[64]

In contrast to the relatively subjective examination required in an assessment of defendants' claims under section 547(c)(2)(A), courts have consistently held that the term "ordinary business terms" contained in section 547(c)(2)(B) implies an objective standard that is based upon the relevant industry.[65] This is a factual inquiry for the bankruptcy court[66] requiring, first, that a court define the relevant industry. Then, the court must consider evidence regarding ordinary business practices in that industry – which may include the testimony of various types of industry experts or evidence of the practices conducted by competitors.

As discussed above, identifying the relevant industry has engendered confusion both before and after the enactment of the BAPCPA. As the Seventh Circuit remarked in *Tolona Pizza Prods. Corp.*, a case involving a pizza business: "[n]ot only is it difficult to identify the industry whose norm shall govern (is it, here, the sale of sausages to makers of pizza? The sale of sausages to anyone? The sale of anything to makers of pizza?), but there can be great variance in billing practices within an industry."[67]

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62 *See, e.g., In re Schick*, 234 B.R. 337, 348 (Bankr. S.D.N.Y. 1999); *see also In re Yurika Foods Corp.*, 888 F.2d 42, 44 (6th Cir. 1989); *In re Fulghum Constr. Corp.*, 872 F.2d at 743; *In re T.B. Home Sewing Enters., Inc.*, 173 B.R. 790, 795 (Bankr. N.D. Ga. 1993); *In re Hancock-Nelson Mercantile Co. Inc.*, 122 B.R. 1006, 1011 (Bankr. D. Minn. 1991).

63 *In re Ahaza Sys. Inc.*, 482 F.3d at 1129; *Kleven v. Household Bank F.S.B.*, 334 F.3d 638, 642 (7th Cir. 2003).

64 *In re Craig Oil Co.*, 785 F.2d 1563, 1566 (11th Cir. 1986) (quotations omitted).

65 *See, e.g.*, *In re Gulf City Seafoods, Inc.*, 296 F.3d 363, 368 (5th Cir. 2002); *In re Kaypro*, 218 F.3d 1070, 1074 (9th Cir. 2000); *In re First Jersey Sec. Inc.*, 180 F.3d 504, 513 (3d Cir. 1999); *In re A.W. & Assocs.*, Inc., 136 F.3d 1439, 1442 (11th Cir. 1999); *In re Carled, Inc.*, 91 F.3d 811, 813 (6th Cir. 1996); *In re Roblin Indus., Inc.*, 78 F.3d 30, 40 (2d Cir. 1996); *In re Midway Airlines, Inc.*, 69 F.3d 792, 797-98 (7th Cir. 1995).

66 *In re Roblin Indus., Inc.*, 78 F.3d at 41.

67 *In re Tolona Pizza Prods. Corp.*, 3 F.3d 1029, 1033 (7th Cir. 1993).

In 2004, the Eighth Circuit held that it is the *debtor's* industry that should be the focus of the "ordinary business terms" analysis.[68] However, other courts have focused upon the *defendant's* industry.[69] At least one court has also suggested that after the BAPCPA courts should examine the industries of *both* parties.[70] For example, in *In re National Gas Distributors*, the Eastern District of North Carolina Bankruptcy Court stated that after the BAPCPA, "ordinary business terms [has become] a separate defense" and accordingly the court ought to consider the "industry standards of both the debtor and its creditors."[71] The *National Gas* court added that "there are general business standards that are common to all business transactions in all industries that must be met."[72] The court did not, however, explain or discuss exactly what constitutes such "general business standards," and commentators have not addressed this issue in any detail.

Interestingly, while the BAPCPA was once thought to *loosen* the standard for preference defendants, if the *National Gas* construct becomes widely accepted, the standard may in fact be *heightened* as a result of the defendant having to establish (and meet) a universal business standard and having to demonstrate that the transaction conformed with industry norms of both creditor and debtor. However, to date, this issue remains unsettled. Tellingly, decisions issued after *National Gas* have not conformed with the *National Gas* court's ruling on the necessity of examining the industries of both creditor and debtor, instead focusing upon the industry of only one of the parties to the transfer.[73] Given the utility of this defense to preference defendants, this issue will likely be addressed by one or more appellate court in the near future.

B. The Ordinary Course of Business Defense and Settlement and Forbearance Agreements

68 *In re Accessair, Inc.*, 314 B.R. 386, 394 (B.A.P. 8th Cir. 2004).

69 *In re Tolona Pizza Prods. Corp.*, 3 F.3d at 1033 (emphasis added); *see also Advo-Sys., Inc. v. Maxway Corp.*, 37 F.3d at 1048.

70 *See, e.g.*, *In re Nat'l Gas Distribs.*, 346 B.R. at 404.

71 *Id*. at 405 (quotations omitted).

72 *See id.*

73 *See, e.g.*, *In re Am. Camshaft Specialties, Inc.*, 444 B.R. at 363-66 (Bankr. E.D. Mich. 2011); *In re Pickens*, No. 06-01120, 2008 WL 63251, at *3 (Bankr. N.D. Iowa Jan. 3, 2008); *In re Hardwood P-G, Inc.*, No. 06-50057-C, 2007 WL 2329811, at *3 (Bankr. W.D. Tex. Aug. 13, 2007); *In re Walterman Implement, Inc.*, No. 05-07284, 2007 WL 4224041, at *3 (Bankr. N.D. Iowa Nov. 27, 2007).

The ordinary course of business defense has occasionally been applied to settlement and forbearance agreements.[74] While some courts have held that payments made pursuant to settlement or forbearance agreements by definition cannot be ordinary course,[75] several other courts, including the Second, Third, Eighth, and Ninth Circuits, have stated that payments made pursuant to restructuring agreements (i.e., consent fees in "lock-up" agreements where lenders agree to vote to support a prearranged or prepackaged plan of reorganization) may, in certain circumstances, be in the ordinary course of business.[76] Predictably, these courts have counseled that any such determination requires an inquiry into the nature of the transaction and the relevant industry involved.

III. Power to Bring Avoidance Actions under Derivative Standing

In general, a trustee or a debtor-in-possession may pursue avoidance actions on behalf of the bankruptcy estate[77] and, in certain cases avoidance actions can be an effective means for a bankruptcy estate to increase creditor recoveries. However, when a trustee or debtor-in-possession does not pursue an avoidance action, creditors (either individually or acting through a committee) may seek "derivative standing" from the bankruptcy court to assert such claims on behalf of the estate.

Nearly all courts have allowed creditors' committees to bring avoidance actions for the benefit of the estate if the committee can establish that a debtor is neglecting its fiduciary duty by *not* bringing such claims.[78] As noted by the Third Circuit: "the ability to confer derivative standing upon creditors' committees is a straightforward application of the Bankruptcy Court's equitable powers … [and] Congress made clear that it intended for the estate to recover property fraudulently transferred by the debtor."[79] Many courts have found that the same standard for derivative standing applies to individual creditors and to creditors' committees.[80] Some courts, however, have set higher standards when an

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74 Payments under a forbearance agreement include, for example, payments made by a debtor to lenders prior to bankruptcy in exchange for the lenders' agreement not to declare a default and exercise remedies.

75 *See, e.g., In re Indus. & Mun. Eng'g. Inc.*, 127 B.R. 848, 850 (Bankr. C.D. Ill. 1990); *In re A. Angelle, Inc.*, 230 B.R. 287, 299 (Bankr. W.D. La. 1998).

76 *See In re Kaypro*, 218 F.3d at 1073 (9th Cir. 2000); *In re Roblin Indus., Inc.*, 78 F.3d at 41-42 (2d Cir. 1996); *In re U.S.A. Inns Of Eureka Springs, Ark., Inc.*, 9 F.3d 680, 685-86 (8th Cir. 1993); *J.P.Fyfe Inc. Of Florida v. Bradco Supply Corp.*, 891 F.2d 66, 70-71 (3d Cir. 1989).

77 11 U.S.C. § 550(a) (2006).

78 Official Comm. of Unsecured Creditors of Cybergenics Corp*. ex rel. Cybergenics Corp. v. Chinery*, 330 F.3d 548, 553 (3d Cir. 2003).

79 *Id.* at 568.

80 *See, e.g.*, *In re Housecraft Indus., USA, Inc.*, 310 F.3d 64, 70-71 (2d Cir. 2002) (a debtor's primary secured creditor has derivative standing to bring claims pursuant to sections 548 and 549 of the Bankruptcy Code under certain circumstances).

individual creditor wishes to prosecute a derivative avoidance action, citing concerns about any recovery benefiting creditors generally.[81] In 2003, the United States District Court for the Southern District of New York found that once a creditors' committee has been permitted to bring a derivative avoidance action, an individual creditor may not also do so.[82]

A small minority of courts have either not addressed the question of whether creditors' committees and individual creditors may bring derivative suits, or have suggested that these parties do not have standing. For example, the Tenth Circuit's Bankruptcy Appellate Panel stated in 2004 that it believed that the literal language of section 548(a)(1) precluded creditors from bringing derivative suits on behalf of the bankruptcy estate.[83] While the Bankruptcy Appellate Panel acknowledged the compelling policy and equitable considerations underlying other courts' conclusions that creditors could bring derivative complaints, it stated that this reasoning is best considered by Congress.[84]

The primary test for whether a party may act as a representative of the estate is whether pursuit of the proposed avoidance actions would result in a benefit to the estate and, further, to the estate's unsecured creditors.[85] Many courts have also emphasized the importance of the approval and supervision of the bankruptcy court with regard to derivative standing,[86] and several courts require the trustee or debtor-in-possession to expressly refuse to pursue the claims prior to granting derivative standing.[87]

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81 *See, e.g.*, *Glinka v. Abraham & Rose Ltd.*, 199 B.R. 484, 493-94 (D. Vt. 1996); *In re Perkey*, 194 B.R. 846 (Bankr. W.D. Mo. 1996).

82 *In re Sunbeam Corp.*, 287 B.R. 861 (S.D.N.Y. 2003).

83 *In re Fox*, 305 B.R. 912, 914 (B.A.P. 10th Cir. 2004).

84 *Id*. at 916. The *Fox* court stated that it was constrained by the literal language of section 548 of the Bankruptcy Code, which states that "the trustee may" avoid fraudulent transfers. 11 U.S.C. § 548(a)(1) (2006). The court recognized that the *en banc* Third Circuit decision in Official Comm. Of Unsecured Creditors of Cybergenics Corp. *ex rel. Cybergenics Corp. v. Chinery*, 330 F.3d 548 (discussed in detail *infra*), as well as other courts, had stretched the statute to confer standing on creditors' committees, especially when the debtor-in-possession had refused to prosecute legitimate fraudulent transfer claims. However, noting a lack of authority in the Tenth Circuit, the Bankruptcy Appellate Panel held that the Supreme Court's decision in *Hartford Underwriters Insurance. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 13-14 (2000) (discussed in detail *infra*) was controlling. While the *Fox* court recognized that the plain language of the statute arguably conflicted with public policy, it found that that public policy concerns alone were not sufficient reasons to ignore the statutory language. *Id*.

85 *See, e.g.*, *In re Tex. Gen. Petroleum Corp.*, 52 F.3d 1330, 1335 (5th Cir. 1995); *In re Maxwell Newspapers, Inc.*, 189 B.R. 282, 287 (S.D.N.Y. 1995).

86 *See, e.g.*, *In re AppliedTheory Corp.*, 493 F.3d 82, 86 (2d Cir. 2007); *In re Commodore Int'l Ltd.*, 262 F.3d 96, 100 (2d Cir. 2001).

87 *See, e.g.*, *In re Gibson Group, Inc.*, 66 F.3d 1436, 1438-46 (6th Cir. 1995); *Louisiana World Exposition v. Fed. Ins. Co.*, 858 F.2d 233, 252 (5th Cir. 1988).

Not all courts, however, have been so strict. In its decision in *In re Housecraft Industries USA, Inc.*, the Second Circuit considered whether the debtor's primary secured creditor had derivative standing to bring claims pursuant to sections 548 and 549 of the Bankruptcy Code when it had signed a joint prosecution agreement with the estate trustee.[88] While the defendant argued that these sections of the Bankruptcy Code only authorize trustees or debtors-in-possession (and not creditors) to bring avoidance claims,[89] the Second Circuit disagreed, holding that, "[a]lthough not explicitly authorized in the [Bankruptcy] Code, we have extended standing to bring fraudulent conveyance claims … to additional parties such as creditors when to do so is in the best interest of the estate."[90] Prior Second Circuit case law had already held that "a creditors' committee may being suit even where the trustee or debtor-in-possession has not unjustifiably refused to do so, so long as (1) the committee has the consent of the debtor-in-possession or trustee; and (2) the court finds that the suit is (a) in the best interest of the bankruptcy estate, and (b) is necessary and beneficial to the fair and efficient resolution of the bankruptcy proceedings."[91] Finding all these elements to be satisfied, the *Housecraft Industries* court granted standing to the secured creditor.[92]

In addition, some courts have held that such a benefit need not occur after the avoidance recovery, but instead may "come directly from the transfer of the claim itself."[93] For example, in *In re Maxwell Newspapers*, the Southern District of New York held that there was a benefit to the bankruptcy estate when creditors, in exchange for the assignment of specific avoidance claims, withdrew a nearly $100 million claim against the estate.[94] There has not been a general consensus across courts concerning the amount of benefit, or the nature of the benefit, that such an assignment must bring to the estate in order to satisfy a "benefit of the estate" requirement. Courts that adopt more liberal interpretations of the extent of "benefit" requirement have held that even indirect, contingent or more attenuated benefits are sufficient to meet the standard. For example, in *Mellon Bank N.A. v. Dick Corp.*, the Seventh Circuit

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88 *In re Housecraft Indus. USA, Inc.*, 310 F.3d at 65-67.

89 *Id*. at 67.

90 *Id*. at 70.

91 *See id* (quotations omitted).

92 *Id*. at 70-72.

93 *I. Appel Corp. v. Val Mode Lingerie Inc.*, Nos. 97 Civ. 6938(LMM), 97 Civ. 8230(LMM), 2000 WL 231072, at *4 (S.D.N.Y. Feb. 28, 2000) (quotations omitted) (citing *In re Maxwell Newspapers, Inc.*, 189 B.R. at 287 ; *see also In re Prof'l Inv. Props. of America*, 955 F.2d 623, 626 (9th Cir. 1992).

94 *In re Maxwell Newspapers, Inc.*, 189 B.R. at 287-88; *see also In re Churchfield Mgmt. & Inv. Corp.*, 122 B.R. 76, 82 (Bankr. N.D. Ill. 1990).

permitted lenders to assert avoidance actions when they advanced funds to the estate pending its sale, despite the fact that the first $30 million of recoveries would go to the lenders themselves and not to the estate.[95]

Bankruptcy courts' ability to grant derivative standing has been impacted by the Supreme Court's 2000 decision in *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*[96] In *Hartford*, the Supreme Court held that a creditor did not have standing to pursue the trustee's right to surcharge a secured creditor's collateral under section 506(c) of the Bankruptcy Code. The express language of section 506(c) states that "*the trustee may recover*" from a secured creditor's collateral under certain circumstances, which led the Supreme Court to conclude that "the trustee is the only party empowered to invoke the provision."[97] The express language of the avoidance action statutes in the Bankruptcy Code contain similar wording, providing that the trustee "may" pursue various sorts of actions.[98] A small minority of courts have held that the Supreme Court's decision in *Hartford* is controlling on this issue. For example in *In re Fox*, the Tenth Circuit's Bankruptcy Appellate Panel found that under *Hartford's* precedent it was constrained by the literal language of section 548. The *Fox* court accordingly refused to grant derivative standing to a creditor.[99]

A majority of courts have continued to allow derivative standing for avoidance actions post-*Hartford*. They have done so by implicitly or explicitly distinguishing *Hartford*. For example, in *In re Cybergenics Corp.*, the Third Circuit Court of Appeals distinguished *Hartford* by asserting that the *Hartford* Court was specifically concerned with *limiting* the rights of a nontrustee.[100] In contrast, the Third Circuit claimed that avoidance actions implicate a different issue – that of "*a bankruptcy court's equitable power* to craft a remedy."[101] The Third Circuit asserted that, as distinct from *Hartford* where a grant of derivative standing would have had the effect of shifting power directly from trustee to nontrustee, in the context of avoidance actions, the assignee of derivative standing acts not in the trustee's *stead* but rather at the bankruptcy court's *discretion*. Therefore, under the Third Circuit's reasoning,

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95 *Mellon Bank N.A v. Dick Corp.*, 351 F.3d 290, 292-94 (7th Cir. 2003).

96 *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. at 13-14.

97 *Id*. at 6.

98 *See, e.g*., 11 U.S.C. §§ 544, 547-50 (2006).

99 *In re Fox*, 305 B.R. at 914.

100 Official Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel. Cybergenics Corp. v. Chinery*, 330 F.3d at 552-53.

101 *See id* (emphasis in original).

while the *Hartford* Court had been motivated by the desire to impose a *limit* on the rights of a nontrustee, the Third Circuit was acting to *protect* the equitable powers of a bankruptcy court. Accordingly, the Third Circuit concluded that its allowance of derivative standing was both justified and consistent with *Hartford*.

Finally, even non-creditors may be granted derivative standing to bring avoidance actions; notably an examiner appointed by the bankruptcy court. The investigatory scope of an examiner's authority is derived from section 1104(c)(1) of the Bankruptcy Code, which provides for the appointment of an examiner "for cause" when it has been demonstrated that such an appointment is in the interest of creditors, equity security-holders, and the estate. Specifically, the Bankruptcy Code empowers courts to appoint an independent examiner to investigate, among other things, allegations of fraud, dishonesty, or gross mismanagement.[102] In addition, section 1106(b) of the Bankruptcy Code authorizes the bankruptcy court to expand the examiner's powers to any other duties of the trustee.[103] For example, in *In re Patton's Busy Bee Disposal Service Inc.*, an examiner was authorized and directed by the Bankruptcy Court to both investigate potential avoidance actions *and* to actually file and prosecute these actions.[104]

IV. The Good Faith Defense under Section 550(b) of the Bankruptcy Code

Under section 550(a) of the Bankruptcy Code, a trustee may recover, for the benefit of the estate, transferred property or its value from either the initial transferee or from subsequent "immediate or meditate" transferees of the original transferee, except as otherwise provided under various other Bankruptcy Code sections including 544, 545, 547, 548, 553(b), and 724(a), and in other particular circumstances. However, under section 550(b), a trustee's right of recovery under section 550(a) is limited. Specifically, a trustee may not recover from: (1) a transferee that has taken for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or (2) any immediate or mediate good faith transferee.[105] Accordingly, applicability of the section 550(b) limitation turns upon, among other things, the good faith of the

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102 11 U.S.C. § 1104(c) (2006).

103 11 U.S.C. § 1106(b) (2006).

104 *In re Patton's Busy Bee Disposal Serv., Inc.*, 182 B.R. 681, 686-87 (Bankr. W.D.N.Y. 1995). *NB*, the *Patton* Court notes that it "agrees with those judges who have looked askance upon attempts to cloak an examiner with all the attributes of a trustee. . . . [but] [f]ar different is the limited assignment of some trustee responsibilities." *Id.* at 685.

105 11 U.S.C. § 550(b) (2006).

transferee. Although section 550(b) does not clearly address the burden of proof, many courts have found that initial and subsequent transferees have the burden of proving their good faith.[106]

Good faith is not defined in the Bankruptcy Code. As Collier on Bankruptcy has remarked, the "unpredictable circumstances in which the courts may find its presence or absence render any definition of 'good faith' inadequate, if not unwise."[107] Courts have generally looked to prior case law for definitions of good faith in the context of avoidance actions. In general, courts have held that good faith requires an arm's length transaction.[108] In addition, if "a transferee possesses knowledge of facts that suggest a transfer may be fraudulent, and further inquiry … would reveal facts sufficient to alert him that the property is recoverable, he cannot sit on his heels, thereby preventing a finding that he has knowledge. In such a situation, the transferee is held to have knowledge of the voidability of the transfer."[109] As one court wrote in an important 1940 decision on the topic, the "question is solely whether the grantee knew or should have known that he was not trading normally but that on the contrary, the purpose of the trade, so far as the debtor was concerned, was the defrauding of his creditors."[110]

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106 *See, e.g., In re Teleservices Group, Inc.*, 444 B.R. 767, 774 (Bankr. W.D. Mich. 2011) ("it is not the trustee who must prove the transferee's bad faith in accepting the transfer. Instead, it is the transferee who must establish that he had acted in good faith."); *In re Consolidated Capital Equities Corp.*, 175 B.R. 629, 637, 639 (Bankr. N.D. Tex. 1994); *In re Nordic Village, Inc.,* 915 F.2d 1049, 1055 and 1055n.3 (6th Cir. 1990); *In re Richmond Produce Co.*, 195 B.R. 455, 463-64 (N.D. Cal. 1996); *In re Custom Contractors, LLC* 439 B.R. 544, 549 (Bankr. S.D. Fla. 2010); *In re American Way Serv. Corp*., 229 B.R. 496, 525 (Bankr. S.D.N.Y 1999); *In re Data Lease Fin. Corp.*, 176 B.R. 285, 287 (Bankr. S.D. Fla. 1994); *see also* COLLIER ON BANKRUPTCY at § 5-550, 550.03[5] ("the better-reasoned position is that, once the trustee has avoided a transfer and established that the property has been transferred to an immediate or mediate transferee, the transferee has the burden to show that it took (1) for value, (2) in good faith and (3) without knowledge of the voidability of the transfer.").

107 COLLIER ON BANKRUPTCY at § 5-548, 548.09.

108 *See, e.g.*, *Bullard v. Aluminum Co. of Am*., 468 F.2d 11, 13 (7th Cir. 1972) (quoting *Holahan v. Henderson*, 277 F.Supp. 890 (W.D. La. 1967)).

109 *In re Sherman*, 67 F.3d 1348, 1357 (8th Cir. 1995); *see also* COLLIER ON BANKRUPTCY at § 5-550, 550.03 ("The Eighth Circuit *Sherman* decision imposes a somewhat more stringent standard.").

110 *In* re *Messenger*, 32 F.Supp. 490, 494 (E.D. Pa. 1940) (citations omitted); *see also Shauer v. Alterton*, 151 U.S. 607, 621 (1894) ("while the plaintiff was not bound to act upon mere suspicion as to the intent with which [the transferor] made the sale in question, if he had knowledge or actual notice of circumstances sufficient to put him, as a prudent man, upon inquiry as to whether [the transferor] intended to delay or defraud his creditors, and he omitted to make such inquiry with reasonable diligence, he should have been deemed to have notice of such fact, and therefore such notice as would invalidate the sale to him, if such sale was in fact made with the intent upon the part of the [transferor] to delay or defraud other creditors"); *In re Agric. Research & Tech. Group, Inc.*, 916 F.2d 528, 535 (9th Cir. 1990) (quoting part of same); *In re Bayou Group, LLC.*, 439 B.R. 284, 310 (S.D.N.Y. 2010) (citing numerous court findings that a transfer is not taken in good faith if the circumstances would place a reasonable person on inquiry of the debtor's fraudulent purpose.).

To be protected from an avoidance action recovery under section 550(b)(1) of the Bankruptcy Code, a mediate or intermediate transferee (i.e., a subsequent transferee) must, like the initial transferee, have received the transfer in good faith (i.e., "without knowledge of the transfer's voidability").[111] Courts have held that, for both transferees and subsequent transferees, such knowledge does not require a "complete understanding of the facts and receipt of a lawyer's opinion that such a transfer is voidable; [rather] some lesser knowledge will do."[112] For example, a court in the Northern District of California held that a transferee did not take in "good faith" where such transferee had sufficient notice when it knew of a debtor's financial difficulties, knew that recent buyout of the debtor was highly leveraged, and knew that the debtor's name appeared as a co-remitter on the check.[113] In general, if one transferee is protected under section 550(b)(1) – i.e., if that transferee has taken for value in good faith and without knowledge of the transfer's voidability – then under section 550(b)(2) that transferee's transferees are also protected from recovery by the trustee so long as these transferees acted in good faith. Notably, a subsequent transferee who does not take in good faith will not be shielded simply by the fact that a predecessor transferee did take in good faith.[114]

V. Duty of Plaintiff to Investigate Affirmative Defenses

There is considerable debate regarding whether avoidance action plaintiffs and their counsel have a duty to investigate obvious affirmative defenses and whether, for the latter, failure to do so may subject an attorney to sanctions under Rule 9011 of the Federal Rules of Bankruptcy Procedure.[115]

There is significant case law suggesting that Rule 9011 does not require a plaintiff to conduct an investigation concerning the merits of *any* affirmative defenses before the case is filed. For example, the Northern District of California Bankruptcy Court stated that Rule 9011 "does not impose a burden on a plaintiff to conduct pre-filing discovery of an asserted defense," but instead merely "requires a plaintiff only to make a reasonable inquiry concerning the factual and legal basis for the plaintiff's own claim."[116]

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[111] *In re First Independence Capital Corp*., No. 05-1618, 2006 WL 1342789, at *1 (6th Cir. May 16, 2006).

[112] *Bonded Fin. Servs., Inc. v. European Am. Bank*, 838 F.2d 890, 898 (7th Cir. 1988) (quoting *In re Nevada Implement, Co*., 22 B.R. 105 (Bankr. W.D. Mo. 1982)).

[113] *In re Richmond Produce Co., Inc*., 195 B.R. at 464.

[114] COLLIER ON BANKRUPTCY at § 5-550, 550.04.

[115] Rule 9011 states that all presentations and claims to the court must: (1) not be presented for an improper purpose; (2) be warranted by existing law and are nonfrivolous; (3) have evidentiary support; and (4) be warranted either by the available evidence or be reasonably based on a lack of information or belief. FED. R. BANKR. P. 9011(b).

[116] *In re W. Die Casting Co*., 106 B.R. 645, 649 (Bankr. N.D. Cal. 1989).

Similarly, a year earlier, the Southern District of Florida Bankruptcy Court stated that a plaintiff "is not required … to determine at his peril, before he files suit, that there is no affirmative defense available to the defendant."[117]

Even in instances when courts have found that plaintiffs and their counsel do have an obligation to investigate affirmative defenses, they face a steep bar in imposing sanctions. Notably, conducting a poor investigation into possible affirmative defenses or making unwise strategic decisions is insufficient. For example, roughly two decades ago in a frequently cited opinion, the Seventh Circuit reversed a bankruptcy court's imposition of sanctions against debtor's counsel under Rule 9011 with respect to several avoidance claims, which the bankruptcy court had previously dismissed on a motion for summary judgment. In that case, the Seventh Circuit found that the plaintiff had investigated possible affirmative defenses, and that the reliance of plaintiff and plaintiff's counsel upon a minority view regarding the ordinary course of business defense did not constitute bad faith.[118] The Eleventh Circuit has opined that the imposition of sanctions would be appropriate only in those most extreme cases in which an estate trustee, the trustee's counsel, or the counsel's law firm acted in "bad faith, vexatiously, wantonly, or for oppressive reasons."[119]

One of the most cogent discussions on this issue is in the 2003 Eastern District of New York Bankruptcy Court decision in *In re Berger Industries, Inc*. In *Berger Industries*, the court considered whether, because the affirmative defenses to section 547 preference actions are contained within section 547 itself, a "pre-filing duty of inquiry or investigation by a plaintiff as to affirmative defenses is no different than that required for a *prima facia* case under 11 U.S.C. 547(b)."[120] After careful consideration, the *Berger Industries* court rejected this proposition, explaining that always "[r]equiring a plaintiff to anticipate affirmative defenses to avoid Bankruptcy Rule 9011 sanctions reorders traditional burdens of pleading and would, in effect, impermissibly change the requirement for a reasonable pre-filing inquiry into pre-filing discovery."[121] At the same time, the *Berger Industries* court found that a "per se rule negating any requirement for a pre-filing investigation" was similarly unacceptable,[122] and opted for a

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117 *In re Concorde Nopal Agency, Inc.*, 92 B.R. 956, 958 (Bankr. S.D. Fla. 1988).

118 *In re Excello Press, Inc*., 967 F.2d 1109, 1115 (7th Cir. 1992).

119 *In re Mroz*, 65 F.3d 1567, 1575 (11th Cir. 1995) (quoting *Chambers v. NASCO, Inc*., 501 U.S. 32, 42-43 (1991)).

120 *In re Berger Industries, Inc*., 298 B.R. 37, 41 (Bankr. E.D.N.Y. 2003).

121 *See id.*

122 *Id.* at 42.

nuanced, fact-specific position: that "any duty of pre-filing inquiry [ought to be] contingent upon the circumstances of the case."[123] Accordingly, how much investigation is reasonable in a given case is a question of line-drawing.[124] While "[o]rdinarily, it will be reasonable for a plaintiff's counsel not to make a pre-filing investigation regarding affirmative defenses … at times an attorney may have a responsibility to examine whether any *obvious* affirmative defenses bar the case."[125]

VI. The Interaction between Avoidance Actions and Sections 502 and 365

A. Section 502

Section 502 of the Bankruptcy Code addresses the allowance and disallowance of claims and interests in a bankruptcy case. In certain situations, section 502 can overlap with the Bankruptcy Code provisions dealing with avoidance actions. In particular, under section 502(d) of the Bankruptcy Code, a creditor's claim may be disallowed by the Bankruptcy Court if that creditor is both the recipient of an avoidable transfer and refuses to either pay "the amount, or turn[] over any such property" for which the creditor has been found liable. A creditor who has simply ignored an avoidance action, and who has had a resultant default judgment lodged against him, falls into this category. In this way, section 502(d) "envisions some sort of determination of the claimant's liability" under the avoidance provisions of the Bankruptcy Code "before [that defendants'] claims are disallowed."[126] As the Fifth Circuit remarked, the "legislative history and policy behind [S]ection 502(d) illustrates that the section is intended to have the coercive effect of ensuring compliance with judicial orders."[127] A practical result of this provision is that creditors must closely monitor bankruptcy proceedings with which they have involvement.

B. Section 365

A debtor's decision to assume an executory contract may act as a complete defense to an avoidance claim. If a debtor elects to assume an executory contract or unexpired lease under section 365 of the Bankruptcy Code, the debtor must, among other requirements, cure all prepetition monetary defaults under the contract.[128] However, it is possible that prior to the petition date, the non-debtor party received certain payments under the contract (other than the payments on which the debtor defaulted) that may otherwise be avoidable under chapter 5 of the Bankruptcy Code (e.g., as preferential payments). In

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123 *Id.*

124 *Id*.

125 *Id*. (quotations omitted).

126 *In re Atl. Computer Sys*., 173 B.R. 858, 862 (S.D.N.Y. 1994).

127 *In re Davis*, 889 F.2d 658, 661 (5th Cir. 1989).

128 11 U.S.C. § 365(b) (2006).

this situation, the debtor must make a decision: either pursue the non-debtor party for the avoidable payments or assume the contract or lease and cure all defaults – in the latter case, courts have held that the debtor must forgo its rights to sue the non-debtor party to recover the otherwise avoidable payments. As the Delaware Bankruptcy Court remarked, "once an executory contract is assumed, the trustee or debtor may not maintain a preference action to recover payments made prepetition pursuant to the contract."[129] The Seventh Circuit has explained that the "language of [section] 365(b)(1) is unequivocal. A party to an executory contract must be paid all amounts due him under the contract before the contract may be assumed."[130] The Seventh Circuit has noted that in "drafting [section] 365(b)(1), Congress went further than requiring that the trustee guarantee payment for future performance under the contract. It required that the trustee guarantee payment of all amounts owed prior to assumption."[131] As the Seventh Circuit reasoned, "Congress passed [section] 365 to insure that a contracting party is made whole before a court can force the party to continue performing with a bankruptcy debtor. Permitting a preference suit after an assumption order would undermine that purpose."[132]

VII. Substantive Consolidation and New Value

Another defense to an otherwise preferential transfer is the "new value" defense under section 547(c)(4). Under section 547(c)(4), a trustee generally may not avoid a transfer to a creditor to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor.[133] "New value" is defined at section 547(a)(2), and "means money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation."[134] Examples of circumstances in which courts have found that new value was provided include: payments made by a transportation company-debtor to a fuel supplier in order to purchase new fuel during the preference period;[135] payments on letters of credit that consequently reduce encumbrances on a debtor's property;[136] and prepetition

129 *In re Philip Servs*. (Del.) Inc., 284 B.R. 541, 553 (Bankr. D. Del. 2002).

130 *In re Superior Toy & Mfg. Co*., 78 F.3d 1169, 1174 (7th Cir. 1996).

131 *Id.*

132 *Id.*

133 11 U.S.C. § 547(c)(4) (2006).

134 11 U.S.C. § 547(a)(2).

135 *In re H&S Transp. Co., Inc*., 939 F.2d 355, 360 (6th Cir. 1991).

136 *In re Fuel Oil Supply & Terminaling, Inc.*, 837 F.2d 224, 229-31 (5th Cir. 1988).

payments of antecedent debts in exchange for a guaranteed loan to a debtor that could not otherwise have been secured.[137]

In most cases, the court's consideration of the new value defense is not complicated by the uncertainty of *who* purportedly received the new value. These waters can be muddied, however, in situations where multiple debtors' cases have been substantively consolidated.

Preliminarily, a bankruptcy court may authorize the affiliated debtor cases to be substantively consolidated where "related debtors' assets and liabilities are so intertwined that it would be impossible, or financially prohibitive, to disentangle their affairs."[138] Substantive consolidation, which has been described as an extraordinary remedy, has not been codified in the Bankruptcy Code,[139] but has been recognized by courts for more than sixty years.[140] Substantive consolidation has been referred to as a "rough approximation of justice" allowed by equity in cases in which "the interrelationships of the group are so hopelessly obscured and the time and expense necessary even to attempt to unscramble them so substantial as to threaten the realization of any net assets for all the creditors"[141] – and, indeed, it can provide a "vital remedy for creditors who were wrongfully misled into extending credit to a debtor (usually because the debtor engaged in fraudulent conduct or otherwise misused its corporate form)."[142]

The existing but scant case law that has considered the overlap of substantive consolidation and the new value defense suggests that where an application of substantive consolidation to the preference period is warranted, a consolidated new value defense will be found appropriate. Conversely, where consolidation is not warranted for the preference period, preference defendants may not assert a consolidated new value defense. The specific facts of each case, along with details concerning parties' interactions and expectations surrounding the transactions, are important factors in courts' consideration of this issue. In *In re Schwinn Bicycle*, the Northern District of Illinois Bankruptcy Court had previously issued an order that provided for consolidation of the co-debtors' estates on an expressly prospective

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137 *In re Kumar Bavishi & Assocs*., 906 F.2d 942, 945 (3d Cir. 1990).

138 *In re Century Electronics Mfg., Inc.* 310 B.R. 485, 488-89 (Bankr. D. Mass. 2004).

139 A narrow exception to this is in the spousal context; *see, e.g.,* 11 U.S.C. § 302(a) (2006); *In* re *Reider,* 31 F.3d 1102, 1108-09 (11th Cir. 1994); Timothy E. Graulich, *Substantive Consolidation—A Post-Modern Trend*, 14 AM. BANKR. INST. L. REV. 527, 527 (2006) [hereinafter Graulich].

140 *See Graulich* at 527n.1 (discussing *Sampsell v. Imperial Paper & Color Corp*., 313 U.S. 215 (1941)).

141 *Chem. Bank N.Y. Trust Co. v. Kheel*, 369 F.2d 845, 847 (2d Cir. 1966).

142 Graulich at 528.

basis.[143] During the preference period, the defendant had dealt with co-debtors separately on separate accounts and with no consolidated liability.[144] The *Schwinn* court found that the language in its consolidation order did not have any retroactive effect and, accordingly, did not merge the co-debtors during the preference period.[145] It also found, given the separate nature of the defendant's dealings with the co-debtors during the preference period, the proper method of calculation for the defendant's new value defense to be on an individualized, debtor-by-debtor basis.[146] Accordingly, the court concluded that a consolidated new value defense was inappropriate (i.e., that the new value defense could not be used indiscriminately by the defendant as to the consolidated co-debtors, and that the co-debtors were not liable for each other's debts).[147]

In *In re Century Electronics Manufacturing*, *Inc*., the bankruptcy court for the District of Massachusetts also addressed the new value-substantive consolidation interplay. As was the case in *In re Schwinn*, a substantive consolidation order had been issued,[148] the language of which the *Century Electronics* court found to be expressly "forward-looking."[149] The court also stated that such substantive consolidation order had been issued for ease of administration, not as a means for the defendant to enlarge its new value defense after the fact.[150] Reasoning that it would be unfair to burden the consolidated estate with a *nunc pro tunc* (i.e., retroactive) application that was not contemplated when the order had been entered, the *Century Electronics* court declared that the defendant could introduce evidence at trial to demonstrate that it had dealt with the co-debtors as a single entity during the preference period, implying

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143 *In re Schwinn Bicycle Co*., 205 B.R. 557, 570-71 (Bankr. N.D. Ill. 1997) (stating that "the Order consolidating these estates had only prospective effect and did not merge the Debtors during the Preference Period.").

144 *Id.* at 565 ("In their usual dealings, Defendant received separate purchase orders from each of the Debtors, sent separate invoices to each of the Debtors, shipped its product to each of the Debtors' dealers separately, received payment from the Debtors' individual operating accounts, and maintained a segregated credit account for each of the Debtors.").

145 *Id.* at 570-71.

146 *Id*. at 565.

147 *Id.* at 570-72. The *Schwinn* court stated: "Contrary to Defendant's contention, the post-bankruptcy substantive consolidation of the Debtors' several bankruptcy estates does not support a calculation on a consolidated basis of the Defendant's new value defense to pre-bankruptcy transactions." *Id.*at 571.

148 *In re Century Electronics Mfg., Inc.*, 310 B.R. at 488, 493.

149 *Id*. at 493.

150 *See id.*

that the new value defense could be applied on a consolidated basis only if the defendant could succeed in its burden of proving consolidation for the relevant time period.[151]

Upon an examination of these cases, it is clear that these courts have not established any *per se* or bright line rules. Rather, the courts' holdings – which ultimately seek to determine whether an application of substantive consolidation is appropriate for the preference period – are sensitive to the facts of each case and the parties' expectations and assumptions regarding the transactions in question.

VIII. Conclusion

As a result of the 2008 recession and the continuing financial distress that it has wrought, there has been a renewed interest in preference and avoidance actions. The determinations made by bankruptcy courts in connection with these claims will have enormous impact on the United States economy, as well as particular industries within it, for decades to come.

151 *See id.* The court further cautioned future bankruptcy parties to "address the issue of retroactivity when requesting substantive consolidation." *Id.*