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A Trade Creditor's Guide to Defending "Wrong Payor" Fraudulent Transfer Cases

By Lucian B. Murley and Neil Steinkamp – November 21, 2013

Although most in-house attorneys, credit managers, and other professionals dealing with credit issues have encountered preferential transfers, fraudulent transfer actions against trade creditors are not as common. This article explains defending wrong payor fraudulent transfer cases, offers guidance in defense strategy and analysis, and explores how to prevent these actions in the first place.

Avoidance Actions: A Brief Overview of Preferences and Fraudulent Transfers
A bankruptcy trustee can sue to recover or "avoid" payments that a creditor received from a debtor prior to a debtor's bankruptcy. (A debtor in possession can also avoid pre-petition transfers. However, because most avoidance actions are brought by a Chapter 7 trustee or a liquidating trustee in a Chapter 11 case, for simplicity's sake this article will generically refer to the party seeking to avoid a pre-petition transfer as "the trustee.") A trustee is empowered with a variety of avoidance actions. The most common is avoiding a "preference" under section 547 of Title 11 of the United States Code (the Bankruptcy Code). An important distinction for the discussion below: In order for the trustee to claw back a payment as a preference, section 547 requires that the payment be "on account of antecedent debt owed by the debtor." In other words, for it to be a preference, the debtor must have paid its own obligation.

But what if a debtor pays a debt that is not its own obligation? For example, assume Debtor A and Debtor B are affiliated corporations. What if the creditor provides the goods to and invoices Debtor A, Debtor B pays the creditor, and then both debtors file for bankruptcy? Under these facts, the payment from Debtor B could not be avoided as a preference under section 547 by Debtor B's bankruptcy trustee. The statute requires that a payment must be "on account of antecedent debt *owed by the debtor*." Debtor B's trustee will likely try to avoid this payment as a fraudulent transfer under section 548 of the Bankruptcy Code. This hypothetical, which is used throughout this article, assumes that Debtor A and Debtor B are not substantively consolidated by the bankruptcy court. "Substantive consolidation" is a doctrine under which the assets and liabilities of ostensibly separate entities are treated as if they belonged to a single entity. *See generally In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005).

An intentional fraudulent transfer is one that the debtor makes with *actual* intent to defraud the creditors. 11 U.S.C. § 548(a)(1)(A). For a constructive fraudulent transfer, the trustee must only establish that certain *circumstances* existed when the transfer was made, and it is not necessary for the trustee to establish the debtor's intent. 11 U.S.C. § 548(a)(1)(B). The most common example of a constructive fraudulent transfer is one in which the debtor (1) received less than a reasonably equivalent value in exchange for the transfer and (2) was insolvent at the time the transfer was made. 11 U.S.C. § 548(a)(1)(B)(i), (ii). Under these "circumstances," the Bankruptcy Code *presumes* that a transfer was fraudulent, and it does not require the trustee to show the debtor's intent.

Defending the Wrong Payor Fraudulent Transfer

There is no one-size-fits-all defense to a wrong payor fraudulent transfer. Rather, the defense analysis is usually fact-sensitive. The following is a summary of possible defenses and strategies.

> **The best defense is a good offense: Taking the fight to the trustee's element of insolvency.** For a 90-day preference action under section 547 of the Bankruptcy Code, the trustee enjoys a presumption that the debtor was insolvent at the time of the transfer. *See* 11 U.S.C. § 547(f). Insolvency is also an element of a constructive fraudulent transfer (*see* 11 U.S.C. § 548(a)(1)(B)(ii)(I)), but in a fraudulent transfer action, as described below, it is much easier for a creditor to attack the trustee's case on insolvency.
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> Both the proof of insolvency and the rebuttal are typically matters of opinion testimony almost always provided by experts retained by the parties. The Bankruptcy Code provides, in relevant part, that "insolvent" means the financial condition such that the sum of the debtor's debts is greater than all of the debtor's property "at fair valuation." 11 U.S.C. § 101(32)(A). Because insolvency is a threshold issue for the trustee's fraudulent transfer, the trustee's case may rise or fall with the trustee's retention of a qualified expert. Conversely, the defendant's rebuttal expert could be the key to a defense victory.
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> **Prior pleadings and orders in the bankruptcy case regarding cash management.** Corporate affiliates often employ some kind of centralized cash-management system. Continuing our hypothetical, assume Debtor A is the operating company and maintains its own bank accounts and receives cash from operations, and then Debtor A transfers or "upstreams" those funds to Debtor B. What if Debtor A and Debtor B file for bankruptcy as jointly administered cases and ask the bankruptcy court to bless their cash-management practices? Does the bankruptcy court's approval mean that pre-bankruptcy payments cannot be fraudulent? To the authors' knowledge, only one reported case has dealt with this argument: *Collins & Airkman Corp. v. Valeo (In re Collins & Aikman Corp.)*, 401 B.R. 900 (Bankr. E.D. Mich. 2009).
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> The defendants in *Collins & Aikman* argued the doctrine of res judicata, which prevents a party from taking one position in litigation and then later taking a "clearly inconsistent"

position. The defendants contended that the debtors could not argue at the beginning of the bankruptcy case (in the cash-management motion) that the cash-management system was important to preserving value and then argue (in the fraudulent transfer action) that payments made to these particular defendants according to that cash-management system were for less than reasonably equivalent value. Without ruling that a defense argument along these lines was categorically invalid, the bankruptcy court rejected the defendants' argument. The court held that the debtors' representations in the cash-management motion related to the debtors' cash management as a whole and that debtors' operations in the future, and that the later allegations of fraudulent transfer against these particular defendants were therefore not "clearly inconsistent" with the cash-management motion.

Although the *Collins & Aikman* court rejected the res judicata argument in that case, the court may have found for the defendants if the facts were slightly different. If, for example, the cash-management motion made broader representations regarding the value of the debtors' cash-management practices, or if the cash-management motion had referred specifically to payments to the defendants, then the outcome could have been different. Creditors should keep this in mind when sued on a wrong payor fraudulent transfer. They should closely review any cash-management motions and orders, and determine whether they can make this defense argument work for them.

Indirect benefit. While courts generally hold that a payment on behalf of a third party's obligation provides no benefit to the paying debtor, some courts have recognized an exception referred to as the "indirect benefit" argument. Determining the "indirect benefit" that the transferring debtor receives is highly fact-specific, and indirect benefit can arise in a variety of situations. In our continuing example, if Debtor A and Debtor B have a cash-management relationship such that Debtor A "upstreams" revenue from its operations to Debtor B, and Debtor B in turn pays Debtor A's customers, such customers' provision of goods or services to Debtor A surely provides an "indirect benefit" to Debtor B. *See, e.g.*, *Kovacs v. Hanson (In re Hanson)*, 373 B.R. 522 (Bankr. N.D. Ohio 2007). The burden is on the defendant-creditor to articulate the value of such benefits to the court. This, too, can be a challenging exercise in the case of benefits whose value may not be intuitive or self-evident. Despite these challenges, in defending the "wrong payor" fraudulent transfer, a defendant should leave no stone unturned in looking for any potential benefit to the transferring debtors.

Defending based on the debtor's cash flows or cash-management practices raises a practical problem: How is an ordinary trade creditor to obtain the information necessary to determine these fact-sensitive defenses? A debtor may provide its secured lender with financial documents showing the flow of funds between the debtor's affiliates, but an ordinary trade creditor would not normally have access to information. It is not easy to obtain discovery from a Chapter 11 debtor early in a bankruptcy case, and it is near impossible to gather this information from a Chapter 7 trustee. Although this information may exist, laying hands on it will probably be difficult and expensive.

Substance over form. "Substance over form" is a basic tenet of fraudulent transfer law. *Boyer v. Crown Stock Dist., Inc.*, 587 F.3d 787, 792 (7th Cir. 2009). If the substance of the supposed "wrong payor" transaction does not appear to be fraudulent, a defendant likely has a strong argument against liability. This "substance over form" idea goes by many names: the step-transaction defense, the integrated-transaction defense, or the collapsing defense. It involves one central tenet: If the payment to the creditor by the debtor was merely a step in a larger transaction, and the larger transaction—when viewed as a whole—did not have a significant negative effect on the debtor, then the payment to the creditor was not fraudulent.

So, in our ongoing hypothetical, where Debtor B pays a customer of Debtor A but Debtor B revenue is upstreamed to Debtor A (figure 1), a court may "collapse" the transaction to its base: the creditor's delivery of product to Debtor A/B and Debtor A/B's payment to the creditor on account of that product (figure 2). The following graphs illustrate this collapsing argument: Because in the collapsed transaction it is merely a case of a debtor paying a creditor on account of an obligation to the debtor, the argument would go, the creditor cannot be liable for a fraudulent transfer.

Figure 1

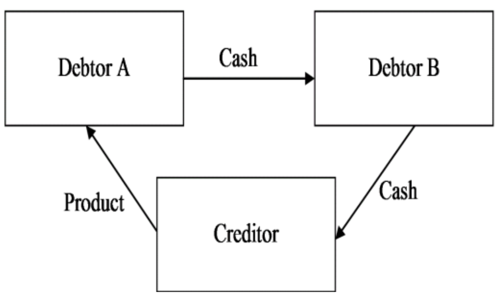
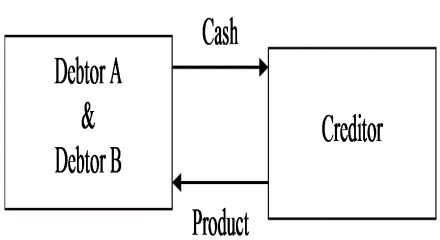


Figure 2



The good-faith and for-value defense. Section 548(c) of the Bankruptcy Code provides that a recipient of a constructively fraudulent transfer has a defense to the extent that the recipient took the payment "for value and in good faith." 11 U.S.C. § 548(c). "Value" is broadly defined in the Bankruptcy Code, *see* 11 U.S.C. § 548(d)(2)(A), but "good faith" is notoriously hard to define. One way to describe good faith is in the negative: If the creditor knew or had reason to know of the debtor's fraud, the creditor is not in good faith. *Hayes v. Palm Seedlings Partners-A (In re Agric. Research & Tech. Grp., Inc.)*, 916 F.2d 528, 535–36 (9th Cir. 1990). Other courts have focused on whether there was anything to put the creditor on "inquiry notice" of the fraud and whether the creditor reasonably followed up on the notice. *Bayou Superfund LLC v. WAM Long/Short Fund II, L.P. (In re Bayou Group, LLC),* 362 B.R. 624, 631 (Bankr. S.D.N.Y. 2007).

Conclusion

Defending a wrong payor fraudulent transfer is significantly different from defending a preference action. Although there is no one-size-fits-all defense, the creditor that investigates the facts and knows the law has the best chance to fend off the trustee.

The businesspeople on the front lines of credit relationships are in the best position to recognize and prevent these issues from arising in the first place. The businesspeople should be aware of the potential issues of accepting a payment from a corporate entity other than the one that appears on the creditor's invoices or contract. Although the parties at the time of doing business may be clear as to who is paying whom on whose behalf, a bankruptcy trustee years later may not understand the transaction from a cold read of the debtor's records.

The most important takeaway from this article should be the importance of documentation. Any document from the time of doing business that sets forth the understanding between the parties—even a simple email between businesspeople—could be the basis for a bankruptcy trustee to walk away from a wrong payor fraudulent transfer. It is critical for creditors to understand these issues and document the transaction *before* their customers run into financial trouble and file for bankruptcy.

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