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Bankruptcy Litigation Strategies for Secured Lenders and Other Creditors

Minimizing Risks of Fraudulent Conveyance, Preference Challenges and Avoidance Actions

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

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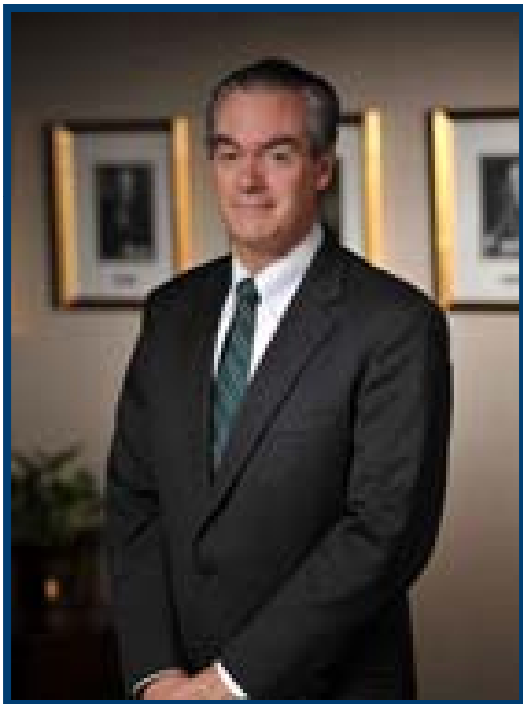
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Minimizing risks

- Fraudulent conveyance actions, Section 548
- Preferences, Section 547
- Other avoidance actions, Sections 549, 544

Minimizing risks

- Nothing works every time.
- Everything works sometime.

Section 547

- Section 547(b)
 - Six elements to prove a preference
- Eliminate one, or more, to win

Section 547

- Section 547(c) - 9 exceptions
- affirmative defenses to plead
- available for transferee to prove

Section 547(b): Property of the debtor – four examples

- Factoring, “true sale”
- No filed UCC-1 financing statements
- “precautionary” financing statements
- skipped bankruptcy litigation
- sued the account debtor post bankruptcy
- DON'T FIGHT UCC ARTICLE 9
- DON'T BE MIA for 8 months

Property of Debtor: No. 2

- Creative financing
 - MBE joint venture financing of fuel oil
- Competing interests:
 - ultimate customer requirement
 - MBE working capital lender with lien on all assets
 - joint venture partner supplier

Property of Debtor: No. 2

- A joint venture between MBE and supplier

[T]he unincorporated association of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership and whether or not the association is called "partnership", "joint venture", or any other name. RUPA.

Property of the Debtor: No. 2

- Bankruptcy courts in various jurisdictions have held that a plaintiff trustee may not avoid a transfer of partnership property as a preference, because no transfer from the debtor's estate has occurred.
- Notwithstanding a very pro-Trustee set of facts, a transfer of corporate property did not qualify as part of the debtor's estate, despite 100% ownership by the debtor, little corporate formality, and rampant fraud.

Property of Debtor: No. 3

- Security deposits, \$25 million, \$7 million
 - Held by third party
 - Periodic renewal of income distribution absent default
- Escrow agreement,
 - Held by third party
 - Trust law, legal and equitable interests
 - Security interest perfect by third party possession

Property of Debtor: No. 4

- Construction lender with perfect UCC filings
- Repossessing equipment supplier
- No delivery, no transfer of risk of loss
- UCC Article 2 can help
- Equipment supplier wins at trial

Section 547(b): Property of the Debtor

- Ownership protection ripples through all the elements

547(b)(4): 90 Days

- Tolling Agreement
- Necessary to step out of routine
- Useful to avoid unnecessary crash
- Prop to emphasize risk

Does a tolling agreement work?

- VERY useful
- Private agreement to change statute
- Stipulation that complaint filed within 90 days
- Estoppel because of wrongful conduct
- Contract in substitution
- Jurisdiction, "related to"

547(b)(4) *Deprizio echoes*

No reported problems for non-insider lender
– two patches in 1994 and 2005

Deprizio echoes

- Waiver of subrogation – failed to protect insider, enforcement denied because can't change statute by private contract, still liable for 1 year preference
- Waiver of subrogation – enforced against insider guarantor who paid
- Awareness for guarantor and lender

Section 547(b)(5): Greater share than Chapter 7

- *United Rentals* equipment supplier
- paid by subcontractor
- loses to subcontractor trustee preference claim
- despite surety
- despite mechanics lien availability
- NOT USED
- No bond claim
- No proof of contractor balance remaining to substantiate mechanic's lien protection
- USE

Greater share

Use Bankruptcy Code protections:

- Section 503(b)(9), 546(c) enhanced reclamation rights
- Section 365 assumption and cure defeats avoidance under Section 547(b)(5)
- Section 546(b) notice of mechanics lien procedures

547(c)(2): Ordinary course

- Evidentiary issue:
- List of preferential transfers
- Exhibit A to demand letter
- Exhibit A to preference complaint
- Some check registers, some analyses
- Object to the summary.
- Different account numbers, the terms and facts varied among the Debtor in possession general ledger accounts. FRE 1006

“Indefeasibly Paid”

- “Indefeasible” used as promise and court order
- Indefeasibility of payment is like finality court order
- Not known until after future events have happened
- Senior lender intercreditor agreement proposal to subordinated lender
- “no payment to subordinated lender until senior lender has been **indefeasibly** paid”

Bankruptcy “proof” settlement

- Here are some ways to minimize likelihood of successful preference attack if debtor files bankruptcy petition within ninety days of settlement.

Structure of Payment

- Structure payment in such a manner that it is not an avoidable preference.

Third Party Payment

- A payment is not preferential if made from assets of third party and effect of payment is not to diminish assets remaining in estate. Third party can be subsidiary or affiliate of Debtor, as long as third party will not itself be debtor in bankruptcy.

Debtor Borrows Money

- If Debtor borrows money from third party to make payment, court might consider payment as having been made to Debtor and from Debtor to creditor, making it an avoidable preference.

Earmarking

- If Debtor must be involved in transaction, funds should be earmarked for payment to particular creditor, they should be paid directly from third party to creditor, lender should become an unsecured creditor of Debtor, and Debtor's control over funds should be minimized.

Purchase of Debtor's Business

- If third party is purchasing Debtor's business or assets, and creditor's consent is required for transaction, creditor should require payment from third party in exchange for providing consent, instead of accepting payment on debt.

Guaranty

- By obtaining guaranty of solvent third party, creditor should be able to shift risk of Debtor's bankruptcy to that party.

Guaranty against preference avoidance

- A solvent third party who would not guarantee payment of debt may be willing to guarantee against preference avoidance.

Ordinary Course of Business

- Because payments made in ordinary course of business on debts incurred in ordinary course of business are excepted from preference recovery, more “ordinary” the circumstances in which payments are made, more likely they are to survive preference attack.

Workout agreement

- Some courts have held payments made under “workout” agreement were made in ordinary course of business, but others have ruled otherwise.

How are debts paid

- The trend in case law seems to be to focus on how often debts are paid in manner in question in particular industry.

Ordinary Course Payment

- A payment made in ordinary course of business between parties or in accordance with ordinary business terms may not be recovered as a preference.

Course of dealing

- Creditors who have established course of dealing with their debtors not at risk of having to return payments made in accordance with that course of dealing, even if that course of dealing differs from industry norm.

Standard Industry Terms

- A creditor who has tolerated practice of stretching payment terms should be able to insist that Debtor pay according to standard terms in industry and not have to return those payments later as preferences because they were “ordinary” in industry (although not ordinary as between creditor and Debtor).

Trust

- To be preferential, a transfer must be made from “an interest of the debtor in property.” May be possible to structure settlement as a return of property of creditor that was held by Debtor in express or constructive trust.

Exception

- If property used to make payment can be traced to creditor as source, payment may be able to survive preference attack. See Henry Bullion Reserve of North America, 836 F.2d 1214 (9th Cir. 1988). However, mere fact that property sold to Debtor is returned to creditor is not sufficient to invoke exception.

Statutory Lien

- Unsecured creditor who has right to obtain statutory lien should perfect lien before accepting payment. For example, creditors having right to claim mechanic's or contractor's lien may be subject to preference recovery if accept payment without first perfecting lien by recording.

Criminal restitution

- Payments made for criminal restitution are not expressly excepted from preference recovery. However, where debt arises out of Debtor's criminal activity, creditor should consider incorporating settlement into order of state court for criminal restitution. See Becker v. County of Santa Clara (In re: Nelson), 91 B.R. 904 (N.D. Cal. 1988).

Transfer of Property

- Transfer of property to the creditor in payment of debt is potentially avoidable as preference. Danger in such a transaction is that property received will be expressly or implicitly overvalued, thereby creating preference liability in excess of what creditor actually received. When seller accepts return of goods from purchaser in shadow of purchaser's bankruptcy, settlement documents should expressly state value of goods to creditor.

Pattern of Transfers

- By observing pattern of transfers that debtor makes in period before bankruptcy, unsecured creditor may be able to predict date on which debtor will file voluntary petition and adjust its own strategy accordingly. For example, if debtor has given mortgage or security interest to secure debt owing to friendly creditor, debtor probably will not file a bankruptcy case until preference period on transfer has expired.

Involuntary Petition

- Creditor who discovers that debtor has made preferential transfers of substantial size should consider filing an involuntary bankruptcy petition against debtor.

Precipitate Bankruptcy

- Until preference period has expired, creditor that has received transfer that may be avoidable should be less willing to take aggressive action that might precipitate Debtor's bankruptcy.

Settlement Agreement

- The following matters should be considered in drafting and executing settlement agreement in shadow of bankruptcy:
 - When will preference period start to run?
Cash check as quickly as possible.
 - Does payment “diminish the estate”?
 - Is third party available to guarantee against preference avoidance?

Structure of Settlement

- If payment is avoided, will original claim be restored? If settlement provides that creditor will accept reduced amount in full satisfaction of debt, agreement should make clear that reduction or satisfaction will only become effective on expiration of preference period. Settlement agreement should provide that if payment is recovered as preference, creditor's claim in bankruptcy case will be for the original amount of debt, plus interest and legal fees, not merely for amount of cash settlement.

Paper trail/non-dischargeability

- Is there preference defense for which paper trail should be developed? Settlement might recite that it is in recognition of creditor's equitable or inchoate lien or parties might consent to judgment that affords equitable relief unalterable by bankruptcy court.
- Should admissions of non-dischargeability be sought? If debt that is subject of settlement involves claim for fraud, embezzlement, willful and malicious injury, or the like, creditor should consider negotiating for admissions that would render settlement non-dischargeable in later bankruptcy case.

Controlling Stock Interest

- If Debtor is corporation, consider obtaining controlling stock interest as collateral. If corporation files under Chapter 11 but owner of shares does not, automatic stay will not prevent repossession and sale of shares because not property of Debtor or estate. Secured creditor may be able to hold meeting of shareholders, oust directors and take control of corporation and case.

Defects in Perfection

- Secured creditor who fears involvement in bankruptcy case should examine carefully security documents and any public filing to make certain that security interest is valid and perfected.

Cure of Defects

- Curing defects in security interest or mortgage before filing of bankruptcy case will not necessarily be sufficient to assure the creditor of secured status. Perfecting of valid security interest constitutes transfer of interest at time of perfection.

Perfected Interest Avoidable

- Interest itself may be avoidable as preference in bankruptcy case filed within ninety days after cure.

Fraudulent Transfer

- Cure will not, in and of itself, constitute fraudulent transfer under Section 548 of Bankruptcy Code because debt that becomes secured will be equal to amount of lien and therefore constitute reasonably equivalent value for it.

Other terms

- Creditor should also review other aspects of loan documents, including those relating to legal fees and default rate of interest, to make sure appropriate for bankruptcy.

Judicial Lien

- Under Bankruptcy Code Section 506(b), holder of secured claim entitled to post-petition attorney's fees and collection costs only to extent provided under security agreement. Holder of judicial lien may not have agreement with Debtor that provides for such attorney's fees and collection costs. Holder of judicial lien should consider negotiating agreement with Debtor that substitutes security interest or mortgage for judicial lien. Security agreement should provide for interest and legal fees and collection costs.

Dissipation of Collateral

- In month before filing bankruptcy cases, debtors often dissipate or misapply collateral. For example, if collateral is accounts receivable, Debtor may collect accounts and spend proceeds in operation of business.

Fiduciary

- Creditor may be able to enter into agreement with Debtor that makes Debtor fiduciary with regard to collateral. For accounts receivable, such an agreement might provide that proceeds of collections of accounts receivable be kept in separate account and held in trust for creditor. If Debtor violates agreement, Debtor's resulting obligation may be non-dischargeable in bankruptcy.

Waiver of Contest of Relief from Stay

- Secured creditor that has opportunity to do so in period before bankruptcy should extract from debtor agreement that, in event of bankruptcy, Debtor waives Debtor's right to contest creditor's motion for relief from stay.

Narrowly Drawn Provision

- Such clause should be narrowly drawn. Should not waive Debtor's right to file petition, which is unenforceable. Nor should it authorize secured creditor to foreclose without first seeking relief from stay.

Waiver

- Waiver should provide that, in event of Debtor's bankruptcy filing, Debtor will not oppose or object to secured creditor's motion for relief from automatic stay.

Waiver

- Courts are especially inclined to enforce waivers in single asset real estate cases, or other cases in which possibility of meaningful reorganization is dim in any event. In these cases, existence of pre-petition waiver strengthens the creditor's post-petition position.

In re Delco Oil, Inc.

**Marathon Petroleum Co., LLC
v. Cohen**

599 F.3d 1255 (11th Cir. 2010)

Facts

- 10/17/06 – Debtor filed for Chapter 11 bankruptcy protection – filed emergency motion to use cash collateral.
- 11/06/06 – Court denied request to use cash collateral.

Post-petition transfers

- Between 10/18/06 and 11/06/06 – Debtor distributed over \$1.9 million in cash to Marathon in exchange for petroleum products.

Use of Cash Collateral

- 12/06 – Case converted to Chapter 7.
- Court stated – Under § 363(c)(2), debtor may only use cash collateral after it has procured the secured creditor's consent or court has permitted such use upon showing secured creditor's interest is adequately protected.

Section 549(a)

- Section 549(a) authorizes trustee to recover unauthorized post-petition transfers of estate property.

Section 550(a)

- Once court finds transfer avoidable, Section 550(a) allows trustee to recover property transferred from initial transferee.

Arguments

- Marathon argued that funds it received from Debtor were not cash collateral.

Arguments

- Cited Section 9-332(b) of UCC – transferee of funds from deposit account takes funds free of security interest in deposit account unless transferee acts in collusion with debtor in violating rights of secured party.

Funds Were Cash Collateral

Court disagreed –

- Secured creditor had security interest in debtor's deposit account funds as proceeds of creditor's properly secured collateral while they were in debtor's hands.
- Therefore – cash proceeds constituted cash collateral.

Unauthorized Transfer

- Court said – trustee could avoid and recover transferred funds because Debtor was not authorized to transfer funds to anyone post-petition without permission of secured creditor or bankruptcy court.

Another argument

- Marathon also argued that deposit account funds did not constitute cash collateral because secured lender did not perfect interest in debtor's deposit account by filing deposit account control agreement.

Court rejected argument

Court also rejected this argument.

- A security interest attaches to any identifiable proceeds of collateral.

Security Interest in Proceeds

- A security interest in proceeds is perfected security interest if security interest in original collateral was perfected.

Perfection

- Secured lender did not have to have deposit account control agreement to perfect its security interest in cash transferred.

Another argument

- Marathon argued that funds received were not identifiable proceeds of secured collateral.

Rejected argument

- But court replied that Marathon's suggestion that there might have been some unidentified source of deposit account funds that was beyond ambit of secured creditor's blanket lien was pure speculation.

No Harm to Estate

- Marathon argued that transfers could not be avoided because any violation of 363(c)(2) caused no harm to estate or secured lender.
- Marathon gave value for the cash transfers.

Rejected Argument

- Court responded – “harmless” exception to a trustee’s Section 549(a) avoiding powers does not exist.

Section 549(a)

- Trustee had to merely satisfy Section 549(a) – unauthorized transfer, property transferred was property of estate and transfer occurred post-petition.

Innocent Vendor

- Finally, Marathon contended it was innocent vendor.
- But – court found no exceptions for innocent vendors in Section 549.

Endnotes

2010 Opinions

- Ta Chong Bank Ltd. v. Hitachi High Technologies America, Inc.*, 610 F.3d 1063 (9th Cir. 2010)(unrecorded notice of assignment of account and months and other litigation defeat factor in AR factoring transaction)
- Wells Fargo Home Mortgage, Inc. v. Dwight R.J. Lindquist*, 592 F.3d 838 (8th Cir. 2010)(delayed recording by assignee of mortgage avoided against originator)
- United Rentals, Incorporated v. Angell*, 592 F.3d 525 (4th Cir. 2010)(equipment supplier not protected by inchoate unfiled mechanics lien or unasserted claim against surety)
- The Liquidation Trust v. Daimler AG (In re Old Carco LLC)*, WL 2925997 (Bankr. S.D. N.Y. 2010)
- In re Electrical Components International, Inc.*, WL 3350305 (Bankr. D. Del. 2010)
- Centrix Liquidating Trust v. Allison Payment Systems, LLC (In re Centrix Financial, LLC)*, WL 3153550 (Bankr. D. Colo. 2010)(Section 365 assumption defeats avoidability under Section 547(b)(5))
- In re Telogy, LLC*, WL 2822092 (Bankr. D. Del. 2010)(sale order finds indefeasible and no fraudulent conveyance)
- In re Nextmedia Group, Inc.*, WL 2745970 (Bankr. D. Del. 2010)
- In re Premier International Holdings Inc.*, WL 2745964 (Bankr. D. Del. 2010)

2009 Opinions

Carrier Corporation v. Buckley (In re Globe Manufacturing Corp.), 567 F.3d 1291 (8th Cir. 2009) (failure to perfect mechanic's lien, state priority for recorded mortgage, and lack of value in building leave contractor losing preference fight).

Miller v. Greystone Business Credit II, L.L.C. (In re USA Detergents, Inc.), 418 B.R. 533, 541-42 (Bankr. D. Del. 2009) (Deprizio waivers of subrogation, contribution, and reimbursement unenforceable effort to avoid statute b contract)

Betty's Homes, Inc. v. Cooper Homes, Inc., 411 B.R. 626 (U.S.D.C. W.D. Ark. 2009) (Ark. law permitting retroactive perfection, Section 546, earmarking and later perfection by materialmandefeat avoidance under Sectio 547(b)(5))

In re Mrs. John L. Strong & Co., LLC, WL 6765349 (Bankr. S.D. N.Y. 2009) (sale order finds no fraudulent conveyance)

In re Velocity Express Corporation, WL 6690931 (Bankr. D. Del. 2009)

In re Lear Corporation, WL 6677955 (Bankr. S.D. N.Y. 2009)

In re Stock Building Supply Holdings, LLC, WL 6667971 (Bankr. D. Del. 2009)

In re Downey Regional Medical Center-Hospital, Inc., WL 6652060 (Bankr. C.D. Cal. 2009)

Some oldies

Levit v. Ingersoll Rand Financial Corp. (In re Deprizio), 874 F.2d 1186 (7th Cir. 1989)

Bankruptcy courts in various jurisdictions have held that a plaintiff trustee may not avoid a transfer of partnership property as a preference, because no transfer from the debtor's estate has occurred. *See, e.g., In re Schick*, 234 B.R. 337, 345 (Bankr. S.D.N.Y. 1999); *In re Cardinal Industries*, 142 B.R. 807, 809-10 (Bankr. S.D. Ohio 1992); *In re Caudy Custom Builders, Inc.*, 31 B.R. 6, 8-9 (Bankr. D. S.C. 1983); *In re Glassley*, 124 B.R. 579, 581 (Bankr. N.D. Okl. 1991).

Notwithstanding a very pro-Trustee set of facts, a transfer of corporate property did not qualify as part of the debtor's estate, despite 100% ownership by the debtor, little corporate formality, and rampant fraud. *In re Levitsky*, 401 B.R. 695, 710 (Bankr. D. Md. 2008) (stating "the assets of a non-debtor corporation do not become assets of the bankruptcy estate of a stockholder of the corporation, even when the individual owns all of the stock").