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Emerging Issues in Bankruptcy Litigation:
Fraudulent Transfers and Preferences
Parties, Pleadings, Forensics, Proof, Remedies,
Final Orders, Coverage, Deep Pockets, and Payoff

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Pleading in the Alternative – Preference v. Fraudulent Transfer

When examining a transfer by or in favor of a debtor that occurred within 90 days preceding a bankruptcy filing, an important initial determination must be made as to whether such transfer qualifies as a preference payment, a fraudulent transfer, or both. A preference involves payment of a debt that violates the bankruptcy principle of equal distribution among all creditors, whereas a fraudulent transfer is a transfer beyond the reach of all creditors of property that would, and should, be property of the estate and distributable among all creditors. A transfer may be both fraudulent and preferential in nature, but identifying the instances in which a transfer is only one or the other is critical.[1] For example, a transfer that may be avoidable as a fraudulent transfer because it was not supported by consideration may not be avoidable as a preference if it was not made on account of an antecedent debt.[2]

One major distinction between preferential and fraudulent transfers is that fraudulent transfers exist both inside and outside of bankruptcy, while preference actions only exist within the bankruptcy context. In a non-bankruptcy context, when an entity is solvent, it can always prefer one creditor over another by choosing which debts to pay and in what order. This favoring one creditor over another is only avoidable as a fraudulent transfer if it involves some element of fraud or seriously effects the transferor's financial situation. While fraudulent transfers occur within the bankruptcy context as well, it important to note that the simple act of favoring one creditor over another absent any fraud may be sufficient in itself to avoid the transfer as a preference based on the potential detriment the transfer could have on the estate's other creditors.

Along these lines, it is also important to note that under section 547, the effect of the transaction controls and a debtor's intent or motive is immaterial when considering an alleged preference.[3] Bankruptcy courts have held that a payment on a pre-existing debt is a loss of value to the estate, and therefore can be avoided regardless of intent.[4]

Conversely, the debtor's intent is the key factor in determining whether a fraudulent transfer has occurred, because, as further discussed below, one must determine whether the transfer was made with the intent to hinder, delay, or defraud the transferor's creditors or estate.[5] In the effort to avoid a transfer as fraudulent, the Trustee bears the burden of proof and must show, by a preponderance of the evidence, that any transfers were made with the actual intent to hinder, delay or defraud any creditor.[6] Proof may be presented through either direct evidence or circumstantial evidence.[7] Commonly, actual intent is proven with circumstantial evidence by

[1] *Dean v. Davis*, 242 U.S. 438, 37 S. Ct. 130, 61 L. Ed. 419 (1917); *In re Roco Corp*. 701 F.2d 978 (1st Cir.1983).
[2] *In re Bouldin*, 196 B.R. 202, 210 (Bankr. N.D. Ga. 1996).
[3] *In re Craig Oil*, 785 F.2d 1563, 1566 (11th Cir. 1986); *Barash v. Public Finance*, 658 F.2d 504 (7th Cir. 1981).
[4] *Freeland v. Enodis Corp*., 540 F.3d 721 (7th Cir. 2008); *In re First Alliance Mort. Co*., 471 F.3d 977 (9th Cir. 2006).
[5] *In re Trace Int'l Holdings, Inc*., 301 B.R. 801 (Bankr. S.D.N.Y. 2003).
[6] *In re The Heritage Org., L.L.C.*, 413 B.R. 438, 464 (Bankr. N.D. Tex. 2009).
[7] *Id.*

establishing sufficient badges of fraud to convince the fact-finder that the requisite intent has been shown.[8]

Perhaps the easiest way to distinguish between a fraudulent transfer and a preference is to focus on the result of the transfer. Did the transfer create or eliminate a debt? Only a fraudulent transfer, and not a preference, results when the transfer involves the creation of an obligation, i.e., signing a guaranty or becoming obligated on a note. A preference can only occur when a transfer eliminates an obligation or debt.

Actual Fraud: Proof For and Against Intent to Hinder, Delay, Defraud 548(a)(1)(A)

After determining whether a transfer qualifies as a preference, one must conduct the more thorough analysis of whether the transfer qualifies as a fraudulent transfer. One avenue, commonly known as actual fraud, requires the trustee to prove that the debtor made the transfer with the requisite intent to hinder, delay, or defraud creditors. Upon satisfying this burden, the recipient bears the burden to prove a defense (see reasonably equivalent value and good faith discussed below).[9] Any one of these three intents is sufficient to prove a transfer qualifies as fraudulent.[10] The debtor need not have made the transfer with malice nor must such transfer have made the debtor insolvent.[11] Further, the trustee is not required to prove the recipient's culpability. Finally, the act of simply preferring one creditor over another does not constitute the intent to hinder, delay, or defraud.[12]

For the court to find that the necessary intent exists, the trustee must show that the debtor intended to interfere with creditors' normal collection processes or with other affiliated creditors' rights for personal or malicious ends. If the debtor enters into a transaction that depletes assets available to creditors with little or no corresponding benefit to the debtor's estate, then the requirements for actual intent can be met.[13] In the *ASARCO* case, the Court looked to the Second Restatement of Torts 8A and determined that the requisite intent is present if the actor knew that harmful consequences were certain or substantially certain to result from his act.[14] Because it is often difficult to prove the intent of a debtor to defraud its creditors utilizing direct evidence, courts often look for the presence of certain badges of fraud for proof of the requisite intent.

Badges of Fraud

While in some situations the intent to hinder, delay, or defraud is apparent on the surface of the transaction, more commonly, certain pieces of circumstantial evidence are present that, taken as a whole, give rise to the inference of fraud. Courts have labeled these circumstances as

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[8] *Id.*
[9] *In re Hannover Corp*., 310 F.3d 796 (5th Cir. 2002).
[10] *Lippe v. Bairnco Corp*., 249 F.Supp.2d 357 (S.D.N.Y. 2003).
[11] *In re Cohen*, 199 B.R. 709, 716-17 (9th Cir. B.A.P. 1996).
[12] *Mayo v. Pioneer Bank & Trust Co*., 270 F.2d 823 (5th Cir. 1959).
[13] *HBE Leasing Corp. v. Frank*, 48 F.3d 623 (2d Cir. 1995).
[14] *ASARCO LLC v. Americas Mining Corp*., 396 B.R. 278, 387 (S.D. Tex. 2008).

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