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A PRIMER ON PREFERENCES AND FRAUDULENT TRANSFERS IN CONSUMER CASES

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The first enumerated duty of a trustee is to "collect and reduce to money the property of the estate…." Bankruptcy Code §704(a)(1). This duty includes the obligation to exercise the powers granted under Bankruptcy Code sections 547 and 548 to avoid preferential and fraudulent transfers. The trustee likewise has authority under section 544(b) to pursue recovery actions that are available to actual unsecured creditors under applicable non-bankruptcy law. This paper addresses those provisions with a particular emphasis on the defenses to those actions and limitations on the parties who may bring these actions.

PREFERENCE ACTIONS – ELEMENTS

A preference is a transfer of an interest of the debtor in property that is made to or for the benefit of a creditor, for or on account of an antecedent debt, is made while the debtor was insolvent, made within 90 days of the commencement of the case,[1] and that enables that creditor to receive more than the creditor would have received had the transfer not occurred and the creditor instead received the amount due to it in a chapter 7 proceeding. The purpose of the provision is to return those funds to the estate so that they can be compiled and redistributed to creditors more evenly and equitably. The provision is also intended to discourage aggressive prebankruptcy recovery actions by creditors so that some debtors are not unnecessarily forced to seek bankruptcy relief. There is some question whether the provision actually accomplishes these goals, but it has been a part of the bankruptcy laws for over a century, and it is not likely that it will be removed from the Bankruptcy Code any time soon.

According to § 547(g), the trustee has the burden of proving each and every element of a preference as set out in subsection (b), and the creditor who is asserting a defense under § 547(c) has the burden of proof on those issues.

I. Transfer of the Debtor's Property

Transfer is defined very broadly in § 101(54) of the Bankruptcy Code and it includes the creation of liens or the retention of security interests, foreclosure of a debtor's equity of redemption, and every other mode of transfer, whether voluntary or involuntary. So, the payment of a debt, the granting of a mortgage or security interest, the completion of a foreclosure or Article 9 sale all constitute transfers under the Bankruptcy Code. We will consider the timing of transfers later in this paper.

II. To or For the Benefit of a Creditor

Preferences relate only to transfers in which a creditor is the direct or indirect beneficiary. So, there must be a debt that is being repaid. A transfer to a non-creditor, essentially a gift, does not result in a preference. Those transfers may run afoul of the fraudulent conveyance provisions, but they are

[1] The 90 day "preference period" is extended back to one year prior to the commencement of the case if the transfer is to a creditor that was an insider.

not preferences. The transfer need not be made directly to a creditor. These "indirect preferences" arise most frequently when the debtor pays a debt that it owed, and the debt had been guaranteed by another party. In that instance, the creditor who received the funds may have gotten a preferential transfer, but the guarantor of the obligation likewise is a preferred creditor. The payment did not go to that person, but they received a benefit from the payment to the extent that his guaranty obligation is reduced.

III. Antecedent Debts

Preferences arise only if the transfer of the interest of the debtor in property is for or on account of an antecedent debt. This is so because those transfers remove value from the debtor and transfer it to a creditor. It makes that value no longer available to the other creditors of the debtor thus "preferring" the paid creditor over the unpaid creditors. If a debtor pays a debt at the time it is created, there is arguably no reduction in the value that would be available to the debtor's other creditors. To illustrate, if a debtor takes $10,000 of cash and uses that money to purchase an asset, the seller of the asset would be a creditor of the debtor (momentarily) who would be receiving a transfer from the debtor. That transfer, however would not harm the debtor's other creditors because they would now have the newly purchased asset available to them to satisfy their claims against the debtor. If, however, the debtor takes $10,000 cash and uses it to pay off an old debt, that creditor does not, at that time, return anything to the debtor that would be available to the other creditors. There is a satisfaction of a debt, but that does not create any value for the other creditors to reach in satisfaction of their claims.

IV. Insolvent Debtors

Preferences arise only if the debtor is insolvent at the time of the transfer. This is simply because a transfer by a solvent debtor to a creditor does not harm other creditors. By definition, a solvent debtor who pays a debt reduces both its assets and liabilities in an identical amount. Thus, if the debtor was solvent before the transfer, the debtor would still be solvent after the transfer and the remaining creditors would suffer no harm from the transfer. Importantly, § 547(f) provides that the debtor is presumed to be insolvent for the 90 day period immediately prior to the filing of the petition in the case. This presumption is rebuttable, but the burden is on the creditor seeking to reverse the presumption.

V. Transfers Within 90 Days of Bankruptcy

Only transfers made 90 or fewer days prior to the filing of the bankruptcy petition are vulnerable to a preference attack, with one significant exception. Preferences made to insiders (as defined in § 101(31) of the Code) are subject to preference attack if they occur within the year prior to the filing of the petition in the case. The notion is that insiders typically have control over the debtor and are in a position to determine the date of the filing of the petition in the case. It would be possible to the insiders to hold off filing until 91 days after they had received a preference, thereby negating the effect of the provision. By reaching back one year to permit a challenge to these transfers, the preference provisions offer greater protection to non-insider creditors.

VI. Enhanced Recoveries by Preference

Under § 547(b)(5), proof of a preference requires a showing the person receiving the preference or benefitting thereby is made better off by the preference than they would have been had the transfer not occurred and instead had gotten only what they would have gotten in a chapter 7 distribution of the debtor's property. This, after all, is the essence of a preference… you were preferred vis a vis the recovery you would have had without that transfer. Proving a debtor is insolvent should be enough to meet this element because if the debtor is insolvent, the creditor will receive more with the transfer than without. To illustrate simply, just assume that a debtor has assets of $10,000 and liabilities of $100,000. With a pro rata distribution of those assets to creditors, each creditor would receive the proverbial "ten cents on the dollar" in a liquidation case. If, however, one creditor whose claim is $11,000 receives a payment of $1,000 from the debtor during the preference period, it will be preferred because the creditor would have the $1,000 in cash as well as a remaining claim against the debtor for $10,000. That $10,000 claim in the bankruptcy would share pro rata with the other creditors from the debtor's remaining assets. In that event, the preferred creditor would receive $10,000 X 9,000/99,000, or $909.10 in the liquidation. That would result in a total recovery of $1,909.10 for the creditor. If the transfer had not been made, however, the debtor's assets would be back to $10,000 and the claims would be $100,000, and the creditor would recover only $1,000 as compared to the $1,909.10.

<u>TIMING OF PREFERENTIAL TRANSFERS</u>

A large part of preference law turns on the timing of the allegedly preferential transfer. Timing of the transfer is crucially important for two parts of a preference case. First, only those transfers that occur during the so-called preference period are subject to avoidance. Second, there must be a gap of time between the creation of the debt and time of the transfer. So, § 547(e) tells us when transfers occur. That provision distinguishes between transfers of interests in real property other than fixtures, and all other property. A transfer of real property occurs when the interest of a seller or purchaser under a contract for the sale of real property is protected against a bona fide purchaser of the property from the debtor. For example, under most state law, if A sells real property to B, but no deed memorializing that transfer is properly recorded under the applicable state law, if A thereafter sells the same property to C who is a bona fide purchaser of the property, C's claim to the property will be superior to B's claim to the property. This rule operates to encourage buyers to record their interests so that no one will be misled into thinking that A still owns the property after he has sold it to B. Section 547(e)(2) refines the timing determination by providing that the transfer is deemed to happen at the time the transfer took effect between A and B if the transfer is properly recorded within 30 days thereafter. If the transfer is not perfected until after those 30 days, then the transfer is deemed to take place for § 547 purposes at the time the transfer is perfected. Finally, if the transfer is not perfected at the later of the commencement of the case or 30 days after the transfer took effect between A and B, then the transferred is deemed to be made immediately preceding the date of the filing of the petition. Generally, though not always, transfers that are perfected within 30 days of the transfer do not pose preference problems. A preference can still occur, as will be demonstrated shortly, even when the transfer is perfected within the 30 days.

As for personal property and fixtures transfers, the Code treats them similarly. The difference is that the transfers of those forms of property are measured against the interests of judicial lien holder. That is, a transfer of personal property occurs when a creditor on a simple contract cannot acquire a judicial lien that would be superior to the interest of the transferee. Again, two illustrations of common situations are helpful. In situation one, a creditor pays cash to a creditor. That transfer takes effect between the parties when the money is handed over. Furthermore, when that money is delivered to the creditor, other creditors of the debtor could no longer obtain a superior interest in that property through the process of judicial action either by attachment, garnishment, or similar means. As for the transfer of a security interest in personal property, illustration 2, the rule of Bankruptcy Code § 547(e)(2) provides that the transfer occurs when the security interest is perfected under Article 9 of the UCC. That perfection makes the secured creditor's interest superior to a lien creditor under UCC § 9-317(a)(2). Once again, the timing rules of § 547(e) then are applied to determine if the transfer is perfected within 30 days of the time the transfer took effect between the transferor and transferee. Moreover, if the transfer is perfected in those first 30 days, it is deemed to have taken place at the time the transfer first took effect between the parties. As noted previously, that circumstance frequently protects these transfers from preference attack. It is not foolproof, however.

For example, assume that on January 1 a debtor owes a creditor $10,000. Assume further that the claim is unsecured. If the debtor cannot pay the debt when it comes due, the creditor might seek some collateral from the debtor to secure the repayment of the obligation. If we assume that the security interest in the debtor's property is created on February 15, and it is perfected under the UCC on February 22, then the transfer is deemed made on February 15 which is the day the transfer took effect between the parties. Nonetheless, the transfer may still be a preference if a bankruptcy case is filed less than 90 days after February 15. The transfer would have taken place during the preference period, and it would have been on account of an antecedent debt. The debt was created on January 1, and the transfer is deemed to have occurred on February 15.

PREFERENCE DEFENSES

Recognizing that some instances in which otherwise preferential transfers occur, there are countervailing policies that outweigh the reasons for permitting the recovery of preferences, Congress has created nine categories of preferential transfers that are not recoverable. These exceptions are set out in § 547(c)(1)-(9).

I. Substantially Contemporaneous Exchanges

These otherwise preferential transfers by the debtor are not recoverable if they are intended to be and are substantially contemporaneous transfers of new value by the creditor to the debtor. These can be any kind of transfer (i.e., the protected transfers are not limited to payments on outstanding debts), and there is some flexibility in the timing of the transfers to allow for the relatively unlimited kinds of circumstances that may exist.

II. Ordinary Course Payments of Debts

The payment of a debt that was incurred in the ordinary course of the business and financial affairs of the debtor and the creditor can be protected against a preference attack by a trustee if that payment is made either in the ordinary course of the business and financial affairs of the debtor and creditor, or the payment is itself made according to ordinary business terms. This exception originally required that the payments be made within a very short period after the debt was incurred, but that restriction has long since left the statute, as has the prior requirement that the payment of the debt. The exception also formerly required that the payment be both made in the ordinary course and according to ordinary business terms, but either of those facts supports the exception today.

III. Purchase Money Security Interests

In keeping with the generally favorable treatment of purchase money security interests, § 547(c)(3) protects from preference attack any purchase money security interest that is perfected on or within 30 days after the debtor receives possession of the collateral. Thus, if a debtor acquires possession of property shortly before the commencement of the case, a security interest in that property will not be subject to recovery by the trustee as a preference if that security interest is a purchase money security interest and the creditor has perfected that interest (typically by the filing of a financing statement under the UCC) not more than 30 days after the debtor comes into possession of the property. It is important to note that possession is the triggering date for the time to perfect.

IV. New Value Transfers

This exception is a statutory version of what had been known as the "net result rule" of preferences. Under this provision, if a creditor extends otherwise unsecured advances of new value to a debtor after the debtor has made a preferential transfer to the creditor. The statute requires that the new value be given by the creditor after the preferential transfer, so in that sense it is not purely a net result rule. That is, one does not simply total the preferences and compare that number to the amount of transfers made to the debtor by the creditor during the preference period. Transfers made by the creditor to the debtor prior to a preferential transfer cannot be used to reduce the preference.

V. Net Result of Inventory and Receivables Transfers

The preference provisions include rules that determine when a transfer occurs. One of those provisions, § 547(e)(3) provides that a transfer cannot occur until the debtor has rights in the property. This has the effect of setting the time of a transfer of inventory generally to the point when the property is sent to the debtor. Of course, this is typically long after the debtor borrowed funds from the creditor. This creates a transfer for an antecedent debt resulting in a preference. The drafters of the UCC attempted to solve this problem by including a section stating that a security interest that attaches to inventory is deemed to be made for a contemporaneous debt. This provision was omitted from the current version of the UCC promulgated in 2001 because it was unnecessary given the adoption of § 547(c)(5) of the Bankruptcy Code. This exception applies to protect preferential transfers of inventory and receivables as long as the creditor's unsecured claim 90 days prior to the commencement of the case is at least as much as the creditor's unsecured claim at the commencement of the case. The test for the exception calls only for the calculation of the amount of the creditor's unsecured claim at those two points in time and ignores any fluctuations of the amount of the creditor's unsecured claim during the intervening period.

VI. Statutory Liens

The creation of a statutory lien is not recoverable as a preference. Such transfers, however, may be recoverable under § 545 as a voidable transfer under the circumstances set out in that provision.

VII. Payment of Domestic Support Obligations

The bona fide payment of a domestic support obligation (DSO) is not recoverable as a preference. A DSO is a prepetition debt owed to a spouse, former spouse, or child of the debtor as long as the debt is in the nature of alimony, maintenance or support, and is established by a prepetition separation agreement, divorce decree or property settlement agreement, or by a court order or by a determination of a governmental unit. This protects this group from losing payments made to them, although the new priority status of these claims enacted in 2005 makes this exception nearly unnecessary.

VIII. Small Payment Exception

The final exceptions are for relatively small payments made during the preference period. In cases of consumer debtors, if the aggregate of payments to a specific creditor during the preference period is less than $600, those transfers are not recoverable. In business cases, the aggregate value of transfers of less than $5,850 to a single creditor that are protected under these exceptions is protected from preference recovery. These two exceptions, set out in § 547(c)(8) and (9), respectively, are intended to protect smaller transfers that are unlikely to be the result of aggressive creditor recovery efforts. They also exist to recognize that creditors generally cannot afford to defend a preference action with such a small amount at stake. These exceptions prevent trustees and debtors in possession from suing in the bankruptcy court where the case is pending and forcing settlements from creditors who may have some defense to the action but who cannot afford to appear in the case. It is important to understand that these sections each provide that the exception is not available if the "aggregate value of all property that constitutes or is affected by such transfer" exceeds the statutory amount. Consequently, if a consumer debtor makes three transfers of $200 each during the preference period, the exception does not apply, and the entire preference is recoverable by the trustee. See, e.g., In re Hailes, 77 F.3d 873 (5th Cir. 1996); In re Alarcon, 186 B.R. 135 Bank. D. N.M. 1995). This is particularly significant for debtors seeking to recover garnished wages that would otherwise be exempt.

LIMITATIONS OF ACTIONS

Section 546 of the Bankruptcy Code sets limitations on the timing of the avoiding powers actions that may be taken by a trustee. Specifically, the Code provides that these actions must be brought at the latest either 2 years after the entry of the order for relief in the case, or one year after the appointment or election of the first trustee in the case. This extended time for a trustee does not apply, however, if the case is more than two years old when the appointment/election occurs. Moreover, the closing of a case cuts off the time to pursue these actions whenever the closing occurs.

These time limitations may not be absolute. Recently, for example, the Sixth Circuit has held that the trustee can challenge a secured creditor's claim by defending an action for relief from the automatic stay by a creditor whose security interest in unperfected. In In re McKenzie, 737 F.3d 1034 (6th Cir. 2013), a creditor with a security interest in the debtor's assets sought relief from the automatic stay. The request for the relief came more than two years after the commencement of the case, so the trustee could not bring an avoiding powers action against the creditor. Nonetheless, the trustee asserted as a defense in the stay litigation that the creditor's claim was disallowable under § 502(d) of the Code. That section provides that if a creditor has received an otherwise avoidable transfer, that creditor's claim is disallowed unless the creditor has turned over the property or repaid the transfer. The decision is consistent with an earlier Seventh Circuit decision, and the Sixth Circuit characterizes its decision as an adoption of the majority rule among the bankruptcy courts. If § 502(d) were read to require a transfer that is still avoidable (and not safe from attack under the avoiding provisions due to the passage of time in the case), the trustee could not use that power to disallow the claim. The Court of Appeals distinguished the case from those prohibiting late filed avoidance power actions by noting that § 502(d) merely disallows the claim and prevents the creditor from sharing in the debtor's estate. Presumably, if the trustee sought to liquidate the asset that was subject to the unperfected interest, the creditor could prevent that action or require that its claim be paid prior to any funds reverting to the bankruptcy estate.

FRAUDULENT TRANSFERS

Another significant avoiding power available to trustees is the power to avoid fraudulent transfers. These transfers may be either actually fraudulent or constructively fraudulent. They may be attacked directly by the trustee under Bankruptcy Code § 548, or by asserting the rights of a holder of an allowed unsecured claim under § 544 of the Code. They provisions tend to be quite similar, though you must be certain of the non-bankruptcy provision which could differ dramatically both as to the statutory language and the applicable case law interpreting those provisions.

I. Actual Fraud

Under the Bankruptcy Code, a transfer made by a debtor that is made with actual intent to hinder, delay, or defraud current or future creditors is avoidable. Given that actual intent is not usually provable by the direct admission during trial of a debtor that the fraudulent scheme did not work, actual fraud is usually proven by proof of the existence of "badges of fraud" to demonstrate the existence of the debtor's actual fraudulent intent. A list of these badges is set out in § 4(b) of the Uniform Fraudulent Transfer Act. They include, inter alia, whether the transfer was to an insider, was concealed, was of substantially all of the debtor assets, and whether the transfer took place at or around the time that the debtor incurred a substantial debt. A number of other badges exist as well, and they have their genesis in Twyne's Case which was decided in 1604. Fraud is certainly not a recent phenomenon. It is important to note that a case based on actual fraud does not require the trustee to prove that the transferee of the property did not provide sufficient value for the asset it obtained. Some defenses may be applicable in that circumstance, but the trustee's burden does not include proving that element.

II. Constructively Fraudulent Transfers

Frequently, a trustee will attack a transfer as constructively fraudulent. In those situations, there is no need to prove any specific intention regarding the transfer. Rather, the elements of the cause of action turn on the debtor/transferor's financial status and the value exchanged between the transferor and the transferee. These cases are brought under § 548(a)(1)(B) of the Bankruptcy Code or an equivalent provision under applicable non-bankruptcy law such as § 4(a)(2) of the Uniform Fraudulent Transfer Act. The trustee in these cases must show that the debtor/transferor did not receive a reasonably equivalent exchange for the property it transferred, and that the debtor was insolvent or rendered insolvent by the transfer or was undercapitalized in its business or intended to incur debts beyond its ability to pay as they matured. The premise of the constructively fraudulent provisions is that insolvent debtors should not be permitted to injure their creditors by squandering the assets that they still have. If the debtor receives a reasonably equivalent value for the property it sells, the debtor's creditors are not injured. Only the makeup of the assets has changed, and the value of those assets is still reasonably equivalent. These provisions prevent debtors from conducting fire sales of their assets to the detriment of their existing creditors.

III. Timing of Transfers

As with preferences, the Bankruptcy Code contains its own rules for determining when transfers occur. Section 548(d) provides that transfers occur for purposes of the fraudulent transfer section when the transfer is so perfected that a bona fide purchaser against whom applicable law permits a transfer to be perfected cannot acquire a superior interest in the property. This brings the role of the recordation of deeds back into play as regards real property transfers. Under this section, many holders of “desk drawer deeds” (that is, deeds given to transferees but not recorded and instead are kept in a desk drawer so that they are available when needed) find that their ownership of the property is not what they thought it was. For example, a debtor or the transferee of real property may have many reasons for not recording a deed. They may be seeking to avoid a tax consequence, they might be hoping that creditors of the transferor do not become aware of the transferor’s ownership of the property, or they may have any number of other reasons for not recording the deed. The deed might not be recorded simply due to the inattention of the parties. Under § 548(d), the transfer of the property would not occur until the proper recordation of the deed. Even if a debtor/transferor were solvent when the deed was executed and delivered to the transferee, if the deed is not recorded until some later time, and the debtor/transferor is insolvent at the time of the recording of the deed, the transfer could be avoided if the transferee did not give a reasonably equivalent value for the property. This circumstance is not rare when family property is transferred from one generation to another. It is a rude awakening, however, when the transfer is deemed for fraudulent conveyance purposes as having taken place long after the original delivery of the deed. The same timing mechanism for real property is included in the Uniform Fraudulent Transfer Act, section 6.

IV. The “Reach Back” Period – Under the Bankruptcy Code

The vulnerability of fraudulent transfers to attack by a trustee is limited by the time of the transfer relative to the time of the bankruptcy case. Under § 548(a), only those transfers that occur within two years of the date of the filing of the bankruptcy petition are avoidable. Prior to 2005, this reach back period was only one year, but that period was extended to two years as a part of BAPCPA. The scope of this reach back effectively extends more than two years in those cases in which the parties to the transfer have failed to perfect the transfer so that the time of the transfer for purposes of § 548 is delayed. So, the delay in recording can result in a very old apparent transfer being deemed to occur in the two years prior to the commencement of the case and thus vulnerable to attack by the trustee.

V. The “Reach Back” Period – Under State Law

The trustee is empowered to bring fraudulent transfer actions under state law if there is a holder of an unsecured claim against the debtor who could, absent the bankruptcy, bring such a case. Section 544(b) allows the trustee to stand in the shoes of that creditor to avoid transfers that the unsecured creditor could avoid under non-bankruptcy law. As noted, this is frequently a state's version of the Uniform Fraudulent Transfer Act, which in large part mirrors the language of § 548 of the Bankruptcy Code.[2] Most significantly, however, state law usually has a longer reach back period than § 548 of the Bankruptcy Code. While that period is two years, the reach back period under the UFTA is generally four years. So, a recipient of a fraudulent transfer that occurred more than two years before the commencement of a bankruptcy case of the transferor of the property would not be subject to an action by the trustee under § 548 of the Bankruptcy Code, but would be subject to a similar claim under state law. States have a wide range of reach back periods under their fraudulent provision statutes. While the UFTA sets a four year reach back, some states reach back seven or more years to permit these recoveries.

VI. The Rule of Moore v. Bay

Significantly, the power of the trustee under § 544(b) actually exceeds the power of the unsecured creditor whose claim the trustee is using to avoid the transaction. In these cases, the trustee has the power to avoid any transfer that the creditor could have avoided, but the trustee is not limited to avoiding the transfer to the extent of the specific unsecured claim on which the trustee is relying. Rather, the trustee can avoid the transfer to the extent of all of the unsecured claims in the case. So, if a transfer is avoidable by one unsecured creditor with a $100 claim, the trustee can avoid the entire transfer rather than just recover $100. Outside of bankruptcy, if the $100 creditor sued to avoid a $1 million transfer, the transferee would simply pay the $100 and the matter would be resolved. When the trustee in bankruptcy brings the action, however, the trustee can avoid the transfer for the benefit of the entire bankruptcy estate. This is the rule of Moore v. Bay, 284 U.S. 4 (1931), and Congress specifically intended to carry this rule forward under the Bankruptcy Code. This greatly expands the power of the trustee and provides substantial leverage when pursuing the avoidance of transfers under state law.

<u>OTHER DEFENSES UNDER SECTION 550</u>

The trustee's avoiding powers are set out in §544, 547, and 548, among others, but these sections largely just set out the elements of those actions. The liability of the transferees and subsequent transferees of the transferred property is set out in 550 of the Code. Under that section, the trustee has the option of recovering the property that was transferred or the value of that property. The Code also provides that the trustee can recovery that property or its value from the initial transferee of the property or any subsequent transferee. Of course, the trustee must be able to trace

[2] There is a move afoot to amend the language of the Uniform Fraudulent Transfer Act to refer to these transfers not as "fraudulent" transfers, but rather as "voidable" transfers. This change, in part, is intended to clarify that the law applies not just to actually fraudulent transfers, but to those that are constructively fraudulent as well. This could also lead to an expanded role for the "hinder and delay" language in the statute.

the property, but everyone in the chain of ownership faces the risk of recovery by the trustee. The Code distinguishes the transferee from subsequent transferees as regards defenses to the trustee's avoidance action. If the trustee is pursuing an action against a subsequent transferee, that transferee has a defense to the action to as long as the transferee took the property for value, in good faith, and without knowledge of the voidability of the transfer. The initial transferee has no such protection. Furthermore, any subsequent transferee from that protected transferee is immune from recovery by the trustee. This is a focused version of the shelter rule that generally applies in commercial transactions.

All defendants in actions under § 550 have a lien on the property being recovered by the trustee to secure the lesser of the costs of any improvements made after the transfer minus any profit realized by the transferee or the increase in value of the property as a result of the improvement of the property. This protection is included in the statute to prevent a windfall to the estate and to recognize the benefit to the property made by the transferee. That increase should not go to creditors who have no connection to the transferee. This protection is included as well in §548(c) which provides that any action to recover a fraudulent transfer under that section . If the transferee takes the property for value and in good faith, the transferee has a lien on or may retain any interest in the property to the extent that the transferee gave value to acquire the property. This is a sensible protection for the transferee. After all, the transferee already contributed the amount of the purchase price to the debtor, and those funds would already be available to the debtor's creditors. Therefore, giving the transferee a lien to protect that amount simply leaves the creditors where they would have been in the absence of the transfer.

STANDING TO BRING PREFERENCE AND FRAUDULENT TRANSFER AVOIDANCE ACTIONS

Sections 547 and 548 each specifically authorize the trustee to bring these actions. There are instances in which the debtor can bring these actions in both chapters 7 and 13. Consider first the potential of a debtor asserting an avoiding power in a chapter 7 case.

Under § 522(h), the debtor may avoid a transfer that the trustee could have avoided under §§ 544, 545, 547, 548, 549, or 724 if the trustee does not take action to avoid the transfer. This power of the debtor is limited to property that the debtor could have claimed as exempt had it been property of the estate as of the commencement of the case. The debtor is them empowered to recover that otherwise exempt property under §550 just as if the trustee had avoided the transfer. Recall that the trustee can recover either the property or its value, and the debtor has that same option. Just as the Code provides that transfers avoided by a trustee are preserved for the benefit of the estate under §551, any transfer that the debtor avoids is also preserved for the benefit of the debtor's exemption. This operates to protect the exemption while also protecting creditors' interests in the property to the extent that they are not subject to avoidance.

The duties of a chapter 13 trustee are set out in Bankruptcy Code § 1302, and they do not specifically include asserting the avoiding powers set out in §§ 547 and 548. Moreover, a chapter 13 trustee does not have any duty to "collect and reduce to money the property of the estate" as does a chapter 7 trustee. Nevertheless, Judge Williamson recently held in In re Cecil, 488 B.R. 200 (Bankr. M.D. Fl. 2013), that a chapter 13 trustee had standing to pursue a fraudulent transaction matter. He noted that § 103 of the Code provides that chapter 5 provision of the Code are applicable in chapter 13 cases, and that § 548 itself authorizes a trustee to bring the action. Finally, he noted that § 323 provides that the trustee is the representative of the estate and has the capacity to sue and be sued. Arguably, the chapter 13 trustee's duty to assist the debtor in the performance of the plan could be cited to support the duty to bring such an action if the debtor's plan calls for the assertion of avoiding actions.

Whether the chapter 13 debtor has standing to pursue these actions is unsettled. The Fifth Circuit has held that chapter 13 debtors have no standing to challenge a statutory lien under § 545 of the Code (In re Stangel, 219 F.3e 498 (5th Cir. 2000) and no standing to take action under § 544 (In re Hamilton, 125 F.3d 292 (5th Cir. 1997). To the contrary, the Sixth Circuit BAP has held that a bankruptcy court order that authorized derivative standing for the debtor if the trustee did not act by a date certain was both proper and prudent. The court in In re Dickson, 427 B.R. 399 (6th Cir. BAP 2010), noted that chapter 13 trustees are often very busy and may not be able to pursue every action that might be available to them. The debtor has a much stronger interest frequently in pursuing these actions, so delegation of that authority makes sense. The court in that case also noted that the best interest of creditors test anticipates the collection of voidable transfers, and policies that further that goal should be encouraged. On the other hand, the court in In re Holcombe, 284 B.R. 141 (Bankr. N.D. Ala. 2001), held that the debtor has no standing to pursue fraudulent transfer or preference actions except to the extent that § 522 allows a debtor to recover otherwise exempt property. The court relied on the Supreme Court's decision in Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A., 530 U.S.1 (2000) where the court held that only the trustee can recover expenses from a secured creditor under § 506(c) of the Code.

AUTOS AND PERFECTION ISSUES

As you have seen, perfection is a key to the protection of a creditor's security interest in an asset. On the flip side, the lack of perfection of these interests is what keeps trustees coming back to the table. For most security interests in personal property, the means of perfection is the filing of a financing statement with the appropriate office (usually the Secretary of State of the state in which the debtor resides). That financing statement must name the debtor and creditor and it must include a description of the collateral. Along with all of this, there must be a security agreement under which the debtor has granted a security interest in the collateral to the secured creditor.

When the collateral is an automobile, however, the means of perfection of the security interest is usually quite different from the normal means of perfection set out above.[3] For the past 30 years or so, perfection of security interests in a motor vehicle owned by a debtor for his or her personal use has

[3] Perfection by the filing of a financing statement is still the norm for motor vehicles that are the inventory of a dealership. When the debtor is the individual owner of the vehicle and using it for personal or household use, perfection is accomplished through the certificate of title notation.

switched from the filing of a financing statement to the inclusion of a notation of lien on the certificate of title for the vehicle. It is commonly understood that vehicles are "covered" by certificates of title, and whenever one decides to purchase a vehicle from another individual, "let me see the car title" is even more important than "let me see the Car Fax." Without the title, the buyer would run the risk that the purported seller is just that, purported. The car may be owned by someone else entirely. So, the existence of car titles has created a new dynamic for the transfer of car ownership.

Not only has it changed the transfer of car ownership, but the car title system has also changed the means of perfection of security interests in vehicles. The UCC provides in § 9-311(a)(2) that the filing of a financing statement is neither necessary nor effective to perfect a security interest in an automobile that is covered by a certificate of title statute if that statutory provision requires a security interest to be indicated on the certificate as a condition of perfection. Note that this provision only relates to the irrelevance of a financing statement as a means of perfection, so that the remaining provisions of Article 9 of the UCC continue to apply to the transaction.

There is no substitute, of course, for the specific language of the certificate of title legislation in particular jurisdiction, but the statutes generally create a similar framework for the perfection of security interests in motor vehicles. The process is slightly different if the vehicle is new or used, so an illustration of each transaction follows.

When a used vehicle is being sold, there is already a certificate of title in existence. It should include the seller's name as the owner of the vehicle, and there will be a space on the certificate where the owner/seller can sign over the title to the new owner. Also on the certificate will be a space that would list any entity that claims a security interest in the vehicle. Any buyer who purchases the car would take it subject to that security interest unless the creditor somehow agreed to the transfer free of its interest. If there is no security interest listed, the buyer would send the now "signed over" title to the appropriate agency (Department of Motor Vehicles, County Clerk, Title Office, etc.) and request that the old title be canceled and a new titled be issued in the name of the new owner. Of course, there will be a fee charged!

For a new vehicle, the process is slightly different. First and foremost, there is no existing certificate of title for the vehicle. Rather, the manufacturer would issue a certificate of origin for the vehicle. When the dealer sells the vehicle to a purchaser, the buyer would need to secure the first certificate of title for the vehicle. This is usually accomplished by the dealer forwarding the certificate of origin and a completed application for the issuance of a certificate of title to the appropriate title office (again, along with the necessary fee). Quick as a wink, or as quickly as the DMV can do it, the new certificate of title is issued and sent to the owner of the vehicle. As we know, however, it is the rare case in which the buyer uses his or her own funds to pay for a vehicle in full. Instead, they usually finance the purchase by borrowing the funds from a third party (bank, credit union, GMAC, etc.) which insists on obtaining a security interest in the vehicle. At that point, the perfection of the third party's security interest becomes important, especially to the lender.

Whether the financed transaction is of a new or used vehicle, the creditor's security interest must be noted on the certificate of title for the lien to be perfected. As previously stated, the presence of the creditor's name on the certificate will notify others (both potential buyers and potential lenders) of the existence of the creditor's interest in the motor vehicle. The secured creditor's interest will be superior to any subsequent lender's interest, and it will continue to attach to the vehicle even if it is sold.

This system works quite well when the rules of the game are followed. It also works well when the owner of the vehicle makes monthly payments until the car is about to completely fall apart, at which time the debt is paid off and the owner can have the secured creditor sign the certificate of title to release the lien, and that certificate can then be submitted to the title agency (again with a fee) to have a "clean" title issued. Notwithstanding your experience as a bankruptcy attorney, this does actually happen.

On many occasions, however, the purchaser of the vehicle files a bankruptcy petition. At that time, the trustee will require the debtor to "show me the title" or will request that the secured creditor that may be in possession of the title to demonstrate its perfected security interest. If the certificate does not include a notation of the creditor's lien, the trustee can avoid the creditor's security interest under § 544 of the Bankruptcy Code via the so-called strong-arm clause. Successful use of the strong-arm clause is unusual when the lender is an institution such as a bank, credit union, or finance company. Family members who lend money to assist with the purchase of a vehicle are more likely to skip the step of noting their lien on the certificate, and their security interests will be avoided.

A more likely challenge that lenders might face from bankruptcy trustees is that the delay in the perfection of the creditor's security interest renders it vulnerable to a preference attack under § 547(b). As previously discussed, a preference is a transfer of an interest of the debtor in property (the security interest in the vehicle is the "property" being transferred) during the preference period that is made on account of an antecedent debt and that enable the creditor to recover more than it would have in the absence of the transfer. The key to the challenge in these cases is the timing of the transfer.

Recall that under § 547(e), the perfection is the transfer that is timed in relation to the moment when the transaction takes effect between the debtor and the creditor. If the transfer is perfected within 30 days of the time it took effect between the parties, then the transfer is deemed to have occurred at the same time as it took effect between the parties. To illustrate, assume that on day one, the debtor purchases a car by borrowing money from lender and giving those funds to the seller of the car. At that time, the debtor also signed a note and security agreement that would create the security interest in the vehicle in favor of the lender. At that time, the transfer took effect between the parties. If the creditor perfects that security interest within 30 days thereafter, the transfer is deemed under § 547(e)(2)(A) to have taken place on day one. Most importantly, this would result in the transfer being one made at the same time as the creation of the debt , and no preference would exist because the transfer was not for or an account of an antecedent debt.

Assume, however, that it is not a perfect world in which all things are done with such precision and alacrity. Rather, there is a delay for some reason in the perfection of the security interest beyond the 30 day grace period provided in § 547(e)(2)(A). In that event, the transfer would take effect at the time of the perfection. So, to adjust the previous scenario slightly, assume that the paperwork generated at the loan closing did not get forwarded immediately to the appropriate office for the issuance of the title certificate with the creditor's lien noted thereon. Instead, on day 60 the security interest becomes perfected. In that case, the transfer for purposes of the preference statute would occur on day 60 according to § 547(e)(2)(B). Since the transfer took place on day 60, and the debt was created on day one, the transfer of the security interest is now a transfer of property of the debtor for or on account of an antecedent debt. If the debtor files for bankruptcy within 90 days after the transfer, the perfection of the security interest can be avoided thereby rendering the creditor unsecured, and the full value of the motor vehicle would be part of the bankruptcy estate. The delay in the perfection of the security interest renders it vulnerable to attack by the trustee.

The key then is to know when perfection occurs under the applicable state law. Some statutes, particularly older versions, provide that the notation of the creditor's lien on the certificate of title is necessary for perfection of the security interest. Others have different requirements for the perfection to take place. For example, in In re Baker, 345 B.R. 261 (D. Colo. 2006), the court held that Colorado law required both the filing of the appropriate documents and the notice of the lien being set out in the government records for the security interest to be perfected. This puts the lender at considerable risk if there is a delay by state agents in making the appropriate notations.

In some states, the legislature has recognized that lenders are at risk due to delays. Not only may the state agents fall behind in their efforts, but it is often the case that the buyer who is borrowing to purchase the car may fail to take some action that has the effect of delaying perfection of the creditor's security interest. In Kansas, for example, a secured creditor may perfect its security interest in a motor vehicle either by a notation of lien on the certificate of title, or it may file with the appropriate state agency a Notice of Security Interest (along with the necessary fee, of course) which satisfies the perfection requirement and is then superseded by the ultimately issued certificate of title. See In re Barker, 358 B.R. 399 (Bankr. D. Kan. 2007).

Close attention must be given to the specific statutory perfection requirements for perfection of the security interest. Remember that the preference provisions base their timing determinations on perfection under state law as against a judicial lien creditor. Section 547(e) then provides a 30 day grace period for perfection that will result in the transfer being deemed to occur at the earlier date.

A final reminder is that the security interest itself must attach before it can be perfected. A recent BAP decision provides this reminder along with a recognition that "grandmas" are special. In In re Giaimo, 440 B.R. 761 (6th Cir. BAP 2010), a grandmother made an interest free loan to enable her granddaughter to buy a car. No load documents were executed, but there was both an application for a certificate of title and the certificate of title that included a notation of the grandmother's lien on the vehicle. The court held that the application and the certificate were sufficient in combination to create a security interest in the vehicle. The court noted that there would be no other reason to complete the application other than to have a lien. The decision was not rendered on Mother's Day. It was, however, published just after Christmas.