Litigation Issues In Avoidance Actions: Hot Topics

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Avoidance actions under sections 544, 547, 548, and 549 of the Bankruptcy Code are a key component of estate administration and often a significant source of funding for the estate and its creditors. If a particular transfer satisfies the elements of one of the foregoing sections of the Bankruptcy Code, section 550(a) empowers the trustee or debtor in possession to recover the property transferred or the value thereof from either "(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or (2) any immediate or mediate transferee of such initial transferee." See Bankruptcy Code § 550(a). The case law regarding avoidance actions is extensive, and trustees, debtors and creditors need to be aware of its contours in order to properly prosecute or defend against preference and fraudulent transfer claims. This note highlights recent notable decisions and developments in the area of avoidance actions.

Adequacy of Pleading Generally

1. Plausibility Standard for Civil Pleadings.

The seminal decisions governing the adequacy of pleadings commencing avoidance actions are Bell Atlantic v. Twombly, 550 U.S. 544 (2007), and Ashcroft v. Iqbal, 556 U.S. 662 (2009). In Twombly, a seven-justice majority held that a complaint failed to state a claim of antitrust conspiracy when it alleged only parallel conduct, which was equally consistent with legal business activity as it was with a pled antitrust violation. In this decision, the Supreme Court effectively ended reliance on the oft-quoted line from its 1957 decision in Conley v. Gibson, 355 U.S. 41 (1957), that "a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." Id. at 45-46. The Twombly Court instead explained that rule 8

of the Federal Rules of Civil Procedure requires that a complaint include facts (as distinct from legal "labels" and "conclusions") giving rise to a "plausible" (rather than merely "conceivable") entitlement to relief. Twombly, 550 U.S. at 555-56. This is often referred to as the "Plausibility Standard." Two years later in Iqbal, the Supreme Court confirmed that Twombly's Plausibility Standard applies to all civil suits. Iqbal, 556 U.S. at 680.

Some commentators have noted that the Plausibility Standard established by the Supreme Court in Twombly and Iqbal dramatically added to the pleading burden on plaintiffs and make dismissal of complaints on the pleadings considerably more likely, while others have noted that these decisions changed little because of evolving court requirements on pleadings. Regardless, as a practical matter, the Plausibility Standard is a critical threshold consideration for litigators drafting complaints in avoidance actions.

2. Enhanced Particularity Requirement for Fraud Pleadings.

Although the notice pleading standard of rule 8(a)(2) of the Federal Rules of Civil Procedure applies to claims for constructive fraudulent transfers, claims for actual fraudulent transfers must satisfy the heightened pleading requirements imposed by rule 9(b) of the Federal Rules of Civil Procedure. See, e.g., In re Cyr, 602 B.R. 315, 328 (Bankr. W.D. Tex. 2019); In re Pitt Penn Holding Co., 484 B.R. 25, 36 (Bankr. D. Del. 2012). Specifically, Rule 9(b) requires that the plaintiff "state with particularity the circumstances constituting the fraud," but "[m]alice, intent, knowledge, and other conditions of a person's mind may be alleged generally." Fed. R. Civ. P. 9(b). The purpose of Rule 9(b) is to "place the defendants on notice of the precise misconduct with which they are charged." Seville Indus. Mach. Corp. v. Southmost Mach. Corp., 742 F.2d 786, 791 (3d Cir. 1984) (abrogated in part on other grounds by Twombly, 550 U.S. at 544). Rule 9(b)'s heightened pleading standard may be satisfied by "specifying the 'who, what,

when, where, and how'; however, what constitutes sufficient particularity under Rule 9(b) will necessarily differ with the facts of each case." Cyr, 602 B.R. at 327 (describing the law in the Fifth Circuit). See also In re AgFeed USA, LLC, 558 B.R. 116, 123-24 (Bankr. D. Del. 2016) ("The Third Circuit has indicated that, allegations of 'date, place or time' fulfill [the heightened pleading requirement], but nothing in the rule requires them. Plaintiffs are free to use alternative means of injecting precision and some measure of substantiation into their allegation of fraud.") (internal quotation marks and citation omitted).

As referenced above, Rule 9(b) does not require, however, that "conditions of a person's mind" be stated with particularity. As the Bankruptcy Court for the Western District of Texas has explained, "Under Rule 9(b), the conditions of Debtor's mind are not subject to the heightened fraud pleading standard, and the trustee need only plead actual intent to hinder, delay, or defraud a present or future creditor generally, with factual allegations that show that relief is plausible." Cyr, 602 B.R. at 327 (citing Fed. R. Civ. P. 9(b)). Accordingly, in order plead an "actual intent to hinder, delay, or defraud" under section 548(a)(1)(A), the plaintiff must "plead such intent with factual allegations that show that relief is plausible." Id. at 329 (citing Iqbal, 556 U.S. at 677–78). It is not necessary that the plaintiff allege "how the transfer was made with actual intent to hinder, delay, and defraud." Cyr, 602 B.R. at 328.

Bankruptcy trustees may have a more relaxed pleading burden under Fed.R.Civ.P. 9(b) because of the nature of their fiduciary role and often lack of familiarity with the debtor. Courts have noted that with respect to actual fraudulent conveyances, the heightened pleading standard of Fed.R.Civ.P. 9(b) is applied, but given the "presumption that [a] Trustee, as a third party, is disadvantaged with respect to information regarding frauds committed against the debtor," "[b]ankruptcy courts have routinely concluded that relaxing the particularity standard of Rule

9(b) is appropriate where the fraud claims are brought by a bankruptcy trustee." In re TMST, Inc., 2019 WL 6883776, at *12 (Bankr. D. Md. Dec. 17, 2019). See also In re Runnymede Capital Mgmt., Inc., 2019 WL 937574, at *9 (Bankr. W.D. Va. Feb. 22, 2019).

3. Pleading Insolvency and Other Elements of Constructive Fraud.

Notwithstanding that Rule 9(b) imposes a heightened pleading standard for actual fraudulent transfer claims, Rule 8(a) nonetheless requires some specificity in pleading a constructive fraudulent transfer claim. For example, in In re PennySaver USA Publ'g, LLC, the Delaware Bankruptcy Court dismissed claims for both actual and constructive fraudulent transfers because the trustee failed to make specific allegations in the complaint identifying the alleged recipients of each of the purportedly fraudulent transfers, though the Court held that it is not necessary to allege which of the debtors actually made the allegedly fraudulent transfers. 602 B.R. 256, 268-69, 272 (Bankr. D. Del. 2019). The Court also explained that it is also necessary for the plaintiff to also identify the date and amounts of each transfer. *Id.* at 268.

Relatedly, insolvency is a key pleading and proof component in most avoidance actions, and the mere rote recitation that the transferor was "insolvent" when the transfer was made should be avoided. Rather, insolvency should be pled with some specificity, although courts are not uniform on this point. As noted by the Bankruptcy Court for the Southern District of New York in Jalbert v. Riverside Machinery Co. (In re Bicom NY LLC), Case No. 19-1314 (MEW) (Bankr. S.D.N.Y. December 12, 2019):

> Courts have reached different conclusions as to whether an allegation that a party was 'insolvent' is sufficient, or whether additional financial details are required at the pleading stage. *See, e.g.,* Pereira v. Cogan, 2001 U.S. Dist. LEXIS 2461, at *8 (S.D.N.Y. Mar. 8, 2001) (holding that a general allegation that a party was 'insolvent' was sufficient); In re Fabrikant & Sons, Inc., 394 B.R. 721, 736 (Bankr. S.D.N.Y. 2008) (same); Boscarino v. Johnson & Wales Univ. (In re Sagarino), 2017 WL 3865625 (Bankr. D. Conn. Aug. 19, 2017) (holding that an allegation that a party was 'insolvent' was impermissibly conclusory); Chorches

v. Catholic Univ. of America, 2017 WL 4638589 (D. Conn. Oct. 16, 2017) (same).

The Court held that the mere allegation that the transferor was insolvent at the pleading stage was sufficient to survive a motion to dismiss. Id. at 3. According to the Court, "insolvency" refers to a specific financial state (that the fair value of liabilities exceeds fair value of assets), and thus, a general pleading of insolvency may be sufficient on its own because it refers to a specific set of facts which will be subjected to proof. Id. at 3-4. However, the Court went on to note that pleading other terms that are used in the fraudulent transfer statutes, such as alleging "unreasonably small capital," do not have the same kind of precise meaning as "insolvency" and apply to a range of facts and judgments, and thus, must be pled with more specificity. Id. at 3.

Conversely, in In re Cyr, 602 B.R. 315, 332 (Bankr. W.D. Tex. 2019), the Court held that a formulaic recitation that a debtor was "insolvent" is insufficient to plausibly allege insolvency. To the Cyr Court, an allegation of insolvency required allegations regarding the value of the debtor's debt relative to the value of the debtor's assets at the time the transfers were made. Id. As the trustee there failed to include such allegations, the Court held that the trustee failed to properly plead insolvency. Id.

4. The Effect of DIP and Cash Collateral Orders on the Ability to Prosecute Avoidance Actions

a. Official Committee of Unsecured Creditors v. The CIT Group/Business Credit, Inc. et al. (In re Jevic Holding Corp.), 2021 WL 1812665, at *4 (Bankr. D. Del. May 5, 2021)

The terms of a debtor-in-possession financing or cash collateral order may affect the ability of a potential plaintiff to prosecute an avoidance action. The Delaware Bankruptcy Court recently addressed this question in the bankruptcy cases of Jevic Holding Corp. and its affiliated debtors, which are more famously known for the Supreme Court's holding that structured

dismissals must adhere to the absolute priority rule. See Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973 (2017).

The predicate for the Supreme Court's decision, however, was a settlement agreement to resolve the litigation between the Official Committee of Unsecured Creditors (the "Committee"), on the one hand, and The CIT Group/Business Credit, Inc. ("CIT") and Sun Capital Partners, Inc. and certain of its affiliates (collectively, "Sun"), on the other hand, whereby the Committee sought to avoid and recover certain allegedly fraudulent transfers made for the benefit of CIT and Sun. Following the Supreme Court's decision, the chapter 11 cases were converted to cases under chapter 7, resulting in the dissolution of the Committee and the appointment of a chapter 7 trustee (the "Trustee"). The Trustee filed a motion seeking to substitute in for the Committee under rule 25(c) of the Federal Rules of Civil Procedure as the real party in interest to prosecute the avoidance action. Official Committee of Unsecured Creditors v. The CIT Group/Business Credit, Inc., 2021 WL 1812665, at *4 (Bankr. D. Del. 2021).

CIT and Sun objected to the Trustee's motion, arguing that the plain language of the final DIP order entered in the chapter 11 cases barred the Trustee from prosecuting the action. Id. Although the final DIP order permitted the Committee and parties in interest to pursue an avoidance action against the debtors' prepetition and postpetition lenders, which included CIT and Sun, within the prescribed "challenge" period (which the Committee did), the debtors, as is common in final DIP orders, explicitly waived their ability to prosecute such a challenge. The final DIP order further provided explicitly that such stipulations were binding on any subsequently appointed chapter 7 trustee. Id. Additionally, CIT and Sun argued that the Trustee can succeed only to the rights, claims and defenses of the debtors, not the Committee. Id.

The Court agreed with CIT and Sun, holding that the plain language of the Debtors' waivers in the Final DIP Order barred the Trustee from prosecuting the Complaint against CIT and Sun Capital. Id. at *7. According to the Court, "the terms of the financing order are paramount in this analysis," and the Trustee's arguments to the contrary disregarded the "key language" in the final DIP order that explicitly barred him from prosecuting the avoidance action. Id. ("The terms of the challenge period carve out are very specific as to *who* may assert a challenge and *when* the challenge may be asserted.") (emphasis in original). The Bankruptcy Court further held, contrary to the trustee's argument, that the Committee's right to assert the fraudulent transfer claims is derivative of the rights of the *debtors*, not their estates, and that the Trustee cannot succeed to the rights granted to the Committee in the final DIP order. Id. at *7-8.

b. Alto Maipo Delaware, LLC, Case No. 21-11507 (KBO) (Bankr. D. Del.)

In the chapter 11 cases of Alto Maipo Delaware, LLC and its affiliated debtors and debtors in possession, the Delaware Bankruptcy Court again demonstrated that the language of a final order may bar an interested party from prosecuting an avoidance action. Like the DIP financing order in Jevic, the final cash collateral order in the Alto Maipo cases provided for a "challenge" period – a period by when an official committee of unsecured creditors or other party in interest could challenge the validity, perfection or amount of the debtors' secured lenders' prepetition liens. On January 31, 2022, just two days before this period was set to expire on February 2, 2022, the Office of the United States Trustee appointed the official committee of unsecured creditors (the "Committee"). On February 3, the Committee filed a motion seeking to extend the challenge period by an additional 60 days, arguing that section 105(a) of the Bankruptcy Code permits the Court to extend the challenge period notwithstanding entry of the

final cash collateral order, and that the Committee would not otherwise have the opportunity to review and confirm the sufficiency and adequacy of the liens of the prepetition secured parties.

The Debtors and prepetition lenders objected to the relief requested by the Committee. Collectively, the objecting parties argued, in part, that (i) the Committee's motion amounted to a request to amend the final cash collateral order which does not satisfy the standards of rule 60(b) of the Federal Rules of Civil Procedure, and (ii) there is no authority under section 105(a) of the Bankruptcy Code or rule 9006(b)(1) of the Federal Rules of Bankruptcy Procedure to support the Committee's request to reopen the challenge period.

The Delaware Bankruptcy Court agreed with the Debtors and lenders and denied the Committee's motion. The Court explained that the finality of final orders outweighs the Committee's ability to pursue an avoidance action for the benefit of unsecured creditors, stating:

> I want to be clear, I take very seriously the fiduciary status of the committee. I also take very seriously and understand the practical reality and the import of my ruling today to the creditor's committee and perhaps their leverage or posture in this case. I am not a spring chicken. I have been told I look like one, but I'm not, but the finality of the order and the importance of final orders weighs in favor of denying the relief today.

Hrg Tr. at 39:16-23 (Feb. 16, 2022). The Court further explained that "there is a significant amount of work that's left to be done in these cases" such that it was "confident that the committee has the opportunity and will have the opportunity to be a zealous advocate on behalf of their clients in this case." *Id.* at 39:24 – 40:5.

Post-Pleadings Recent Decisions and Developments of Note

1. Extraterritoriality

Courts must sometimes consider whether Section 550 applies to transfers that are made outside the United States. The United States Court of Appeals for the Second Circuit addressed this issue in In re Picard, 917 F.3d 85 (2d Cir. 2019), which involved a consolidated appeal of

dismissals by the bankruptcy court (as affirmed by the district court) of 88 avoidance actions initiated by the trustee of Bernard L. Madoff Investment Securities, LLC ("BLMSI"). Id. at 91. The trustee sought to recover transfers that BLMIS had made to certain foreign investment "feeder" funds and that those funds, in turn, had made to their own customers. Id. The appellees were hundreds of foreign subsequent transferees received payments from the foreign feeder funds. Id. at 93. The specific issue being considered by the Second Circuit was whether "the presumption against extraterritoriality or international comity principles limit the reach of 550(a)(2) such that the trustee cannot use it to recover property from a foreign subsequent transferee that received the property from a foreign initial transferee." Id. at 91. The lower courts had answered these questions in the affirmative and dismissed the avoidance actions. Id.

The Second Circuit reversed the dismissals of the 88 avoidance actions. First, the Second Circuit concluded that the fraudulent transfer provisions of the Bankruptcy Code governed a debtor's own transfers which deplete the estate (i.e., the initial transfer by the debtor) and that Section 550(a) is a remedy provision that is "merely the means by which the statute achieves its end of 'regulating and remedying the fraudulent transfer of property.'" Id. at 98 (quoting WesternGeco LLC v. ION Geophysical Corp., 138 S.Ct. 2129, 2138 (2019)). Thus, the Court held that Section 550 is not a means of regulating foreign transfers between foreign entities, but rather, is a remedy that governs domestic U.S. transactions. Id. at 99. So long as the debtor's own transfers took place in (or originated in) the United States, the "remedy" set forth in Section 550 may have extraterritorial effect without offending the principles set out by the Supreme Court that federal statutes apply only within the United States and do not have extraterritorial effect in the absence of an expressed Congressional intent to the contrary. See id. at 100. See also RJR

Nabisco, Inc. v. European Cmty., 136 S.Ct. 2090, 2100 (2016); Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247, 267 (2010).

Second, the Second Circuit concluded that international comity considerations do not bar the trustee from recovering the property transferred by the debtors. The Second Circuit did not find persuasive the fact that many of the feeder funds were in liquidation proceedings abroad and that those foreign courts may have an interest in recovering the funds as well. Id. at 103-04. The Second Circuit explained that any interest of a foreign court is not "compelling enough to limit the reach of a federal statute that would otherwise apply here." Id. Accordingly, "the United States' interest in applying its law to these disputes outweighs the interest of any foreign state" and comity considerations did not bar recovery by the trustee. Id. at 105.

2. Safe Harbor Under Section 546(e)

Section 546(e) of the Bankruptcy Code, commonly referred to as the "safe harbor" provision, provides, in part, that a trustee or debtor-in-possession may not avoid a transfer "by or to…a financial institution…in connection with a securities contract" other than under an intentional fraudulent conveyance theory. The majority of the circuit courts, including the Second, Third, Sixth, Eighth and Tenth Circuits, agreed that the presence of a qualifying financial institution in a securities-related transaction, even when that institution served solely in the role as a mere conduit, triggered the safe harbor protections of 546(e) for the entire transaction. Other circuit courts, including the Seventh and Eleventh Circuits, ruled that the mere presence of a qualifying financial institution in a securities-related transaction as an intermediary or conduit is not sufficient to trigger the protections of Section 546(e).

In Merit Management Group LP v. FTI Consulting, Inc., 138 S. Ct. 883 (2018), on appeal from the Seventh Circuit, the Supreme Court resolved this split among the circuit courts. The

Merit Court held that section 546(e) does not automatically insulate a transfer solely because it was effected through a "financial institution" that served as a mere conduit to complete the overall transfer. Id. at 888. The Court held that "the only relevant transfer for purposes of the safe harbor is the transfer that the trustee seeks to avoid." Id. In other words, the Court ruled that courts must look at the entire overarching transfer sought to be avoided, not the individual transactions between intermediaries in isolation, in determining whether the transfer falls within the safe harbor of Section 546(e).

Notably, the definition of "financial institution" in section 101(22) of the Bankruptcy Code is defined to include not just Federal reserve banks and commercial or savings banks, among other types of entities, but also "customers" of any such entity when the entity is acting as agent or custodian in connection with a securities contract. 11 U.S.C. § 101(22). The Merit decision left open the question of whether a debtor's or transferee's status as a "financial institution" on this basis would affect the outcome of the case: "The parties here do not contend that either the debtor or petitioner in this case qualified as a financial institution by virtue of its status as a 'customer' under §101(22)(a)." Merit, 138 S. Ct. at 890 n. 2. Thus, the Supreme Court did not decide whether a principal-agent relationship between a debtor and a financial institution protects a particular transfer under Section 546(e).

The Second Circuit, however, answered this question in the affirmative in In re Tribune Company Fraudulent Conveyance Litigation, 946 F.3d 66 (2d Cir. 2019). There, the Second Circuit considered whether certain payments made to shareholders in connection with a leveraged buyout tender offer fell within the safe harbor of section 546(e). The debtor had retained a trust company and bank called Computershare Trust Company, N.A. ("Computershare") – a "financial institution" for purposes of section 546(e) – to act as depositary

in connection with the tender payments to shareholders. Id. at 77-78. As such, Computershare "performed multiple services" for the debtor, including receiving and holding the aggregate purchase price for the shares, receiving and retaining the tendered shares, and paying the tendering shareholders. Id. at 78. Based on these facts, the Second Circuit found that the debtor was a customer of Computershare and that Computershare was also acting as the debtor's agent. Id. Therefore, the debtor also constituted a financial institution and the transfers were shielded from avoidance under section 546(e) because they were made in connection with a securities contract for the benefit of the debtor. Id.

The Second Circuit's decision greatly expands the application of section 546(e) and significantly reduces the impact of Merit. At least one court has taken issue with the Second Circuit's holding. In In re Greektown Holdings, LLC, the Bankruptcy Court for the Eastern District of Michigan criticized the Second Circuit's agency analysis, explaining:

> Under Tribune's analysis any intermediary hired to effectuate a transaction would qualify as its customer's agent. And consequently, if such an intermediary would be a financial institution, the debtor's status would transform to one of a financial institution itself. This would result in a complete workaround of Merit Management, which opined that the safe harbor provision does not insulate a transfer simply because a qualified intermediary acted as a mere conduit.

621 B.R. 797, 827 (Bankr. E.D. Mich. 2020). According to the Court, a more fulsome analysis of agency principles under common law is required to determine whether a principal authorized the agent to act on its behalf. Id. Nonetheless, the Second Circuit's decision remains good law.

3. Does "New Value" Have to Remain Unpaid?

Section 547(c)(4) provides that a preferential payment may not be recovered to the extent that "after such transfer" the creditor gave "new value to or for the benefit of the debtor" that was not secured by an otherwise unavoidable security interest and on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor. See

11 U.S.C. § 547(c)(4). In practice, proving new value is relatively simple when there are just one or two transactions and it is clear from the evidence that the new value was extended after the preferential transfers. But often the proof involves a series of rolling transactions between the creditor and the debtor in which the creditor ships repeatedly and the debtor makes numerous payments on account of various shipments. Courts have struggled to determine how to calculate new value in those instances.

The United States Court of Appeals for the Eleventh Circuit addressed this question in Kaye v. Blue Bell Creameries, Inc. (In re BFW Liquidation, LLC), 899 F.3d 1178 (11th Cir. 2018). In that case, Blue Bell provided ice cream products to the debtor on credit over the course of the preference period, and the debtor made numerous payments to Blue Bell in exchange for those goods even though the debtor had an outstanding balance owed to Blue Bell for deliveries that were made before the preference period. The trustee of the debtor's estate argued that the deliveries of the ice cream products served to offset the preference payments to Blue Bell *only* to the extent that the new value "remained unpaid" as of the petition date—and, as a result, that Blue Bell's defense could not apply to most of the transfers since it was, in fact, actually paid for most of the more recent ice cream deliveries. In re BFW Liquidation, LLC, 899 F.3d at 1182.

The "remain unpaid" approach provides that a payment to a creditor on account of previously delivered new value will forfeit the defense as to that payment. Only delivery of new value that is not subsequently paid off by the debtor (in other words, value that "remain[s] unpaid") is available to reduce the creditor's preference exposure for previously received payments.

The Court of Appeals disagreed with the trustee, ruling that section 547(c) does not require that new value "remain unpaid," but instead merely requires that the new value has not

been paid for "with an otherwise avoidable transfer." The Court stated that, "so long as the transfer that pays for the new value is itself avoidable, that transfer is not a barrier to assertion" of the new value defense. Id. at 1188–89.

In Blue Bell Creameries, the Eleventh Circuit joined the Fourth, Fifth, Eighth, and Ninth Circuits in holding that there is no "remain unpaid " requirement in section 547(c)(4), which now appears to make this the majority approach on this issue. This approach broadens the protections to vendors and encourages them to ship to struggling customers because of the diminished risk that payments for their goods or services will be clawed as preferences. Notably, however, the minority approach on this issue remains alive. In re Calumet Photographic, Inc., 2019 WL 220229, at *1 (Bankr. N.D. Ill. Jan. 9, 2019) ("At issue before the court is the purely legal question of whether the law of [the Seventh Circuit] still holds that only unpaid new value can be used by a creditor to reduce preference liability under 11 U.S.C. § 547(c)(4)(B). . . . [T]he court concludes the answer to that question is yes.").

4. The "Earmarking" Defense

The general goal of avoidance litigation is to equalize treatment among creditors by recapturing value that favored the transferee over the other remaining creditors. At times, however, the property transferred by the debtor was not property which would have otherwise been available to the other creditors of the debtor. For example, the debtor could have borrowed funds specifically to pay the transferee. Those funds were not available to the other creditors, and the debtor's transfer of those funds did not diminish the overall pool of funds available to the other creditors.

In litigations seeking to avoid these kinds of transfers, defendants have sought to apply the so-called "earmarking" defense to those payments. The argument is that the payments the

payment at issue was not from assets of the debtor's estate, and therefore should not be treated as payment that can be avoided.

Two recent decisions have addressed the availability of the "earmarking" defense. *See* Feldman v. People First FCU (In re White), 2019 WL 2067360 (Bankr. E.D. Pa. 2019); In re Wagenknecht, 2019 WL 2353534 (BAP 10th Cir. June 4, 2019).

The White decision arose out of an action to recover a transfer that had allegedly been made in violation of section 549 of the Bankruptcy Code. The court explained that a transfer is exempt from avoidance under the earmarking doctrine if three elements are established: (1) the existence of an agreement between the new lender and the debtor that the new funds will be used to pay a specified debt; (2) performance of the agreement according to its terms; and (3) the transaction as a whole does not result in any diminution of the debtor's estate.

In White, the funds at issue had been withdrawn *pre-petition* by the debtor from her 401(k) account and were then used post-petition to pay her mortgagee in order to stop a foreclosure on her residence. Pursuant to section 541(c) of the Bankruptcy Code, the funds in the 401(k) account, while they were in that account, were not part of the debtor's bankruptcy estate. When the trustee sought to avoid the transfer pursuant to Section 549, the mortgagee argued that the funds that the earmarking defense should apply.

The court disagreed. The court found that when the funds were withdrawn from the 401(k) pre-petition, the funds ceased to be part of the 401(k) fund and became property of the debtor, and then became property of her bankruptcy estate upon the filing of the petition. The funds lost their status as non-estate property. Thus, the court held that the mortgagee could not meet its burden of establishing the first element of the earmarking defense because the 401(k)

funds did not, in fact, come from a new lender, but instead came from the debtor's own account at the time of the filing.

In Wagenknecht, the bankruptcy court rejected the proposed application of the earmarking defense, holding that the defense was limited to situations in which codebtors were involved. While the BAP did not directly address the issue of earmarking because it was not directly appealed, the BAP did address the question of whether the transfer at issue was "of an interest of the debtor in property under 547(b)(1).

In Wagenknecht, the debtor's obligation to a law firm was paid by the debtor's mother who contemporaneously received a promissory note from the debtor on account of her payment to the law firm. The chapter 7 trustee sought to avoid the payment to the law firm as a preference under section 547(b) of the Bankruptcy Code. The law firm argued that the payment had actually been made by the debtor's mother and thus, that "there was not a transfer of an interest of the [d]ebtor, and the estate was not diminished by the payment to the [law firm]."

The BAP held that the transfer was an interest of the debtor in property and, therefore, a preferential transfer that the trustee could avoid. The BAP held that the transfers to the law firm effectively amounted to debtor directing the use of borrowed funds to pay another debt, which amounted to transfer of property in which the debtor had an interest. The law firm argued that the use of the funds was not "discretionary" because a condition of the loan was that it "be used exclusively to pay the specific debt owed to the [l]aw [f]irm and for no other purpose." The BAP ruled that this argument ignored the debtor's "role in the transaction." The court noted that "[i]f the transferred funds had been a gift, the [d]ebtor would have had no control, but that the promissory note between the debtor and his mother was evidence that the debtor exercised control of the loan proceeds, because he agreed to repay his mother and he had the option of

refusing the loan if the proceeds were not distributed to him. Thus, the Court ruled, even though the loan proceeds were only fleetingly an asset of the debtor's estate (by virtue of the payment direction), they nevertheless should be recovered as an avoidable transfer and distributed to the debtor's creditors.

However, on appeal from the BAP, the Tenth Circuit Court of Appeals reversed, ruling that because the debtor did not exercise control or dominion over the payment to the law firm, and because the payment did not diminish the bankruptcy estate, the payment did not constitute a "transfer of an interest of the debtor in property" under Section 547(b). Matter of Wagenknecht, 971 F.3d 1209 (10th Cir. 2020).

5. Avoidance of Tuition payments by Insolvent Parents for Their Adult Children.

Recently, bankruptcy courts have grappled with the issue of whether a debtor parent's payment of tuition on behalf of their adult child constitutes a constructive fraudulent transfer under Section 548(a)(1)(B). While the courts are split as to the answer, in the first known appellate decision on this topic, the First Circuit concisely and succinctly held that such tuition payments are constructive fraudulent transfers under the Bankruptcy Code. DeGiacomo v. Sacred Heart Univ. Inc. (In re Palladino), 942 F.3d 55, 59, n. 3 (1st Cir. 2019).

The debtor parents in that case, who pled guilty to fraud for operating a Ponzi scheme, paid $64,656.22 in tuition payments for their 18-year old daughter to attend Sacred Heart University before declaring bankruptcy. The trustee sought to avoid the tuition payments made by the debtors. In holding that the tuition payments were avoidable as constructive fraudulent transfers pursuant to Section 548(a)(1)(B), the First Circuit reasoned that such tuition payments "deplete[ ] the estate and furnish[ ] nothing of direct value to the creditors who are the central concern of the code provisions at issue." Id., at 59.

While this decision will likely fuel further recovery actions by trustees on these kinds of tuition payments, this is a hot-button political issue and could well give rise to legislation seeking to insulate these payments.

6. Small Business Restructuring Act of 2019.

The Small Business Restructuring Act of 2019 went into effect on February 19, 2020. The focus of the SBRA is to create a new Subchapter V of Title 11 which is aimed at streamlining and facilitating smaller chapter 11 cases, which is outside the scope of this note.

Notably, however, the SBRA includes revisions to Section 547(b) and 28 U.S.C. § 1409(b). Prior to the SBRA, Section 547(b) gave broad authority: "the trustee may avoid any transfer of an interest of the debtor in property" that meets the elements of a preferential transfer set forth in the section. The SBRA changes the section by adding additional due diligence requirements. The SBRA adds the following underlined language to section 547: "the trustee may, based on the reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses under subsection (c), avoid any transfer of an interest of the debtor in property" that meets the elements of a preference. This revision markedly increases the pre-pleading due diligence and the pleading burden on the plaintiff in preference actions.

The SBRA also amends the venue provision of 28 U.S.C. § 1409(b) by increasing the statutory threshold from $10,000 to $25,000 for covered proceedings that must be commenced in the *defendant's* district. This revision will reduce small preference actions against defendants located outside the debtor's home venue who previously would have been pushed to settle primarily, if not solely, because of the cost of having to appear in the debtor's home venue.