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Avoidance Action Report

A Quarterly Report on the Latest Case Law Relating to Avoidance Actions and Other Bankruptcy Issues.

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Delphi: Another Case Where The Heightened Pleading Standards Of *Twombly* And *Iqbal* Are Applied To Preference Actions

Bankruptcy Courts have begun to apply the Supreme Court's heightened pleading standards enunciated in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007) ("*Twombly*") and *Ashcroft v. Iqbal*, 129 S.Ct. 1937 (2009) ("*Iqbal*") to preference actions. The latest court to do so is the Bankruptcy Court for the Southern District of New York in the bankruptcy case of *In re DPH Holdings Corp. et al* ("*Delphi*"); Case No. 05-44481(RDD).

On October 8, 2005, Delphi Corporation, a global technology manufacturer, filed for bankruptcy under chapter 11 of the Bankruptcy Code. In August of 2007, right before the two year statute of limitations for filing avoidance actions was to expire, the Debtor filed an *ex parte* motion to file several hundred avoidance action complaints under Bankruptcy Code Section 547 under seal, which the Court granted. The Debtor argued that it was necessary to file the complaints under seal to preserve its ability to avoid the transfers if and when necessary without harming the Debtor's current business relationships with the Defendants. The Debtor then filed over 700 avoidance actions unbeknownst to the Defendants. The Debtor also obtained 4 extensions of time to serve the complaints beyond the 120 day deadline for serving complaints provided by Bankruptcy Rule 7004 (which incorporates Rule 4(m) of the Federal Rules of Civil Procedure). The motion to approve filing the complaints under seal and requests for extensions were *ex parte* to the majority of the Defendants.

Bankruptcy Code Section 547 states: "the trustee may avoid any transfer of an interest of the debtor in property–
(1) to or for the benefit of a creditor;
(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
(3) made while the debtor was insolvent;

(4) made–
(A) on or within 90 days before the date of the filing of the petition; or
(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
(5) that enables such creditor to receive more than such creditor would receive if–
(A) the case were a case under chapter 7 of this title;
(B) the transfer had not been made; and
(C) such creditor received payment of debt to the extent provided by the provisions of this title."

Over 2 years after the complaints were filed under seal, the Debtor served the complaints upon the Defendants. Eighty-three of the Defendants filed motions to dismiss the complaints asserting, among other things, that the complaints were defective and were not sufficiently pled under the heightened pleading standards of *Twombly* and *Iqbal*, which set forth what claims for relief must include under Rule 8 of the Federal Rules of Civil Procedure (which is applied to bankruptcy adversary proceedings under Bankruptcy Rule 7008).

Rule 8 states that a complaint must contain, among other things, "a short and plain statement of the claim showing that a pleader is entitled to relief." Prior to *Twombly* and *Iqbal*, courts held this to mean that a complaint should not be dismissed for failure to state a claim unless it appeared "beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957).

In *Twombly*, an antitrust case, the United States Supreme Court stated that while factual allegations need not be detailed to survive a motion to dismiss for failure to state a claim under Rule 8, they require more than "labels and conclusions, and a formulaic recitation of the elements of a cause of action." The Supreme Court further stated that allegations contained in the complaint must be sufficient to raise a right to relief beyond mere speculation, and must state enough factual matter to make a claim "plausible." In *Iqbal*, the Supreme Court held that the heightened pleading standards set forth in *Twombly* apply to all civil suits in federal courts, not just antitrust cases.

At the July 22, 2010 Delphi omnibus hearing, the Court analyzed whether the preference actions were sufficiently pled under *Twombly* and *Iqbal* (the Court entertained the notion that *Twombly* and *Iqbal* may not apply to the preference actions because they were filed prior to *Twombly* and *Iqbal*, but concluded that the heightened pleading standards applied).

Applying *Twombly* and *Iqbal* to the complaints, the Court held that the complaints were not sufficiently pled under Rule 8 for three reasons: (1) the complaints did not identify which of approximately 40 debtors were the transferors; (2) the complaints did not allege the particular antecedent debts on account of which the transfers were made; and (3) some of the complaints listed multiple defendants in the same action, but did not assert which defendants were initial transferees and which were subsequent transferees (Bankruptcy Code Section 550 provides limitations on avoiding transfers received by subsequent transferees).

Notwithstanding, the Court did not dismiss the complaints outright, but afforded the Debtor 45 days to file motions to amend the complaints and instructed the Debtor to file a separate motion for each complaint with a copy of the amended complaint attached to each motion. In September 2010, the Debtor filed motions for leave to file amended complaints, with hearings scheduled for December 16, 2010.

Delphi follows recent bankruptcy courts applying *Twombly* and *Iqbal* to preference actions, including the following:

***In re Caremerica, Inc.*, 409 B.R. 737 (Bankr. E.D. N.C. 2009)**. In *In re Caremerica, Inc.*, the

Plaintiff sued the Defendants under Bankruptcy Code Sections 547 and 548 seeking to recover preferential and fraudulent transfers. The Defendants filed motions to dismiss alleging that the complaints were not sufficiently pled under Rule 8. The Court, applying the heightened pleading standards of *Twombly* and *Iqbal*, granted the Defendants' motions to dismiss. The Court reasoned: (1) the complaint failed to meet the "plausibility" standard because it did not indicate which debtor entity initiated the transfers in question; (2) the complaint's allegation that the preferential transfers were made for or on account of an antecedent debt was conclusory; and (3) the complaint failed to factually demonstrate that the Debtor was insolvent.

***In re Troll Communications, LLC*, 385 B.R. 110 (Bankr. D. Del. 2008)**. In *In re Troll Communications, LLC*, the Plaintiff sued the Defendant under Bankruptcy Code Sections 547 and 548 seeking to avoid and recover preferential and fraudulent transfers. The Defendant filed a motion to dismiss asserting that the Plaintiff did not sufficiently plead "insolvency" because certain facts that the Debtor pled relating to insolvency were inconsistent with facts contained elsewhere in the complaint. The Court held that notwithstanding the apparent inconsistencies in the complaint, the Plaintiff sufficiently pled the allegation of insolvency because the allegation was supported by specific factual statements and not mere conclusory allegations. The Court noted that a plaintiff is only required to plead sufficient facts, not prove them, to survive a motion to dismiss.

Commentary

Delphi and the other recent cases exemplify that preference actions have become subject to the heightened pleading requirements set forth in *Twombly* and *Iqbal*. Form complaints with bare recitations of elements that may have survived motions to dismiss under Rule 8 prior to *Twombly* and *Iqbal*, may now be subject to dismissal. Notwithstanding, courts have been pragmatic and liberal in allowing plaintiffs leave to amend complaints. Practitioners prosecuting avoidance actions should seek to provide as much factual support for each cause of action. Practitioners defending avoidance actions should scrutinize complaints to see if they could be dismissed on the basis that they are not sufficiently pled under Rule 8, *Twombly* and *Iqbal*. For a copy of the July 22, 2010 *Delphi* hearing transcript, please email info@neigerllp.com.

Ability To Avoid Transfers To Former Insiders May Vary Under Bankruptcy Code Sections 547 And 548

***In re Transtexas Gas Corp.*,**
597 F.3d 298 (5th Cir. 2010)

***In re Netbank, Inc.*,**
424 B.R. 568 (Bankr. M.D. Fla. 2010)

In re Transtexas Gas Corp. and *In re Netbank, Inc.* exemplify a distinction between Bankruptcy Code Sections 547 and 548 with respect to whether a transfer to a former insider is treated as a transfer to an "insider" for purposes of avoiding the transfer. In *In re Transtexas Gas Corp.*, the Court held that a transfer to a former insider is avoidable under Section 548. However, in *In re Netbank, Inc.*, the Court held that a transfer to a former insider is not avoidable under Section 547.

In re Transtexas Gas Corp.,
597 F.3d 298 (5th Cir. 2010)

In *In re Transtexas Gas Corp.,*U.S. National Bank Association, as liquidating trustee for the chapter 11 estate of Transtexas Gas Corp., brought an avoidance action under Section 548 against the Debtor's former CEO to set aside $2 million in severance payments as fraudulent conveyances. The severance agreement was signed while the Defendant was an insider, but the payments were made after the Defendant's resignation.

Under Section 548(a)(1), "a trustee may avoid any transfer … that was made or incurred on or within 2 years before the date of the filing of the petition, if among other things, the debtor —
… made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business."

The Plaintiff argued that the payments were fraudulent transfers under Section 548 because the payments were arranged while the Defendant was an insider of the Debtor. The Defendant argued that the payments were not fraudulent transfers under Section 548 because the payments were made subsequent to the Defendant's departure from the company, and, therefore, he was not an "insider" when the payments were made.

The Bankruptcy Court held that the transfers were avoidable because the Defendant was an insider at the time the transfers were arranged. The Defendant appealed, and the District Court affirmed the Bankruptcy Court's ruling. The Defendant appealed again.

The Court of Appeals for the Fifth Circuit affirmed the District Court and the Bankruptcy Court, and held that the transfers could be avoided under Section 548. The Court reasoned that Section 548 sets forth that a transfer may be avoidable if the recipient was an insider at the time of the transfer <u>or</u> at the time the obligation was incurred. Thus, because the Defendant was an insider when the severance agreement was executed, the Court ruled that the transfer was avoidable under Section 548 even though the Defendant was not an insider at the time of the transfer.

In re Netbank, Inc.,
424 B.R. 568 (Bankr. M.D. Fla. 2010)

In *In re Netbank, Inc.*, the liquidating supervisor for the estate of Netbank, Inc. brought an avoidance action under Section 547(b) against the Debtor's former CEO to set aside an alleged $2.9 million preferential transfer. The transfer occurred one day after the transferee's resignation as the Debtor's CEO, which was prior to 90 days but within one year before the petition date. Therefore, the transfer could only be avoided if the Defendant was an "insider" under Section 547.

Under Section 547(b), a trustee may avoid certain transfers made to a creditor between ninety days and one year before the date of the filing of a bankruptcy petition, if such creditor at the time of such transfer was an insider.

The Plaintiff contended that the pertinent date for determining whether the Defendant was an insider was the date the Debtor agreed to make the transfer, which was when the Defendant was still the Debtor's CEO. The Defendant filed a motion to dismiss arguing that the Plaintiff's complaint failed to state a claim under Section 547 because he was no longer an insider on the date the transfer actually occurred.

In its analysis, the Court noted that the majority view was that the pertinent date is the date the transfer was actually made. This is known as the "exact date" approach. The Court also mentioned that a minority of courts adopt an "arranged transfer" approach, which looks at whether the transferee was an insider on the date the transfer was arranged.

The *Netbank* Court followed the majority "exact date" approach and held that because the Defendant was not an "insider" on the date of the transfer, the transfer was not avoidable under Section 547(b), and granted the Defendant's motion to dismiss. The Court's reasoning included: (1) the "arranged transfer" approach is inconsistent with the plain meaning of the statute, which requires that a defendant be an insider at the time of the transfer and (2) the "exact date" approach provides a bright line for determining whether a transfer is avoidable.

<u>Commentary</u>

In re Transtexas Gas Corp. and *In re Netbank, Inc.* demonstrate that even if a former insider transferee may be insulated from liability under Section 547(b), it may still face exposure to liability under Section 548 if the transfer was arranged while he or she was an insider. In determining whether a transfer to a former insider is avoidable, practitioners must undertake a 3 step analysis. First, the practitioner must determine whether the transfer in question was arranged when the transferee was an insider. Second, the practitioner must analyze whether the transfer in question is being avoided under Section 547 or Section 548. Finally, the practitioner must be aware of whether courts in the relevant district and circuit apply the "exact date" approach or the "arranged transfer" approach.

Courts Continue To Refine The "New Value" Defense

In re TI Acquisition, LLC,
429 B.R. 377 (Bankr. N.D. Ga. 2010)

In re Commissary Operations, Inc.,
421 B.R. 873 (Bankr. M.D. Tenn. 2010)

In re TI Acquisition, LLC and *In re Commissary Operations, Inc.* (which was discussed in the last issue of the Avoidance Action Report) analyze whether a creditor could use the "new value" defense in connection with goods for which it received a Section 503(b)(9) claim.

In *In re TI Acquisition, LLC*, the Court held that a creditor cannot use the shipment of goods received by a debtor within 20 days prior to filing for bankruptcy as the basis for a new value defense under Section 547(c)(4) if the creditor received a Section 503(b)(9) claim for the goods <u>and</u> will be paid in full on such claim. In *In re Commissary Operations, Inc.*, however, the Court held that Bankruptcy Code Sections 503(b)(9) and 547 are not mutually exclusive and a creditor can assert the new value defense in connection with the provision of goods for which it received a 503(b)(9) claim.

In re TI Acquisition, LLC,
429 B.R. 377 (Bankr. N.D. Ga. 2010)

In *In re TI Acquisition, LLC,* the Debtor, a manufacturer of carpeting and textiles, brought an adversary proceeding to avoid alleged preferential transfers pursuant to Section 547(b) for amounts it paid the Defendant within 90 days prior to filing for bankruptcy. The Debtor received the goods in question within 20 days prior to the petition date, for which the Defendant received an administrative claim under Section 503(b)(9).

Section 503(b)(9) provides that a creditor may receive an administrative expense priority claim in connection with goods received by the debtor within 20 days prior to the commencement of a bankruptcy case.

Section 547(c)(4) provides a defense to the avoidance of a preferential transfer to the extent the creditor provided new value to or for the benefit of the debtor after such transfer.

The Debtor filed a motion for partial summary judgment under Federal Rule of Bankruptcy Procedure 56 and Federal Rule of Civil Procedure 56(c) seeking a determination that the Defendant should not receive payment on its Section 503(b)(9) claim <u>and</u> reduce its preference exposure to the extent it will receive such payment, as it would allow the Defendant to receive duplicate value for the goods it shipped.

The Court held that a creditor that delivers goods to a debtor pre-petition is not entitled to the new value defense under Section 547(c)(4) of the Bankruptcy Code when (1) such creditor receives a Section 503(b)(9) claim for such goods, and (2) it is certain that the creditor will be paid in full on such claim. The Court reasoned that while a creditor's knowledge of the availability of the new value defense

under Section 547(c)(4) encourages continued commerce with a prepetition debtor, there is no difference from the creditor's pre-petition perspective in incentive to ship goods if it instead receives value in the form of payment on a 503(b)(9) claim. The Court specifically noted that in this case, Section 503(b)(9) claims were guaranteed to be paid in full, and that it may have arrived at a different conclusion if the Debtor's estate was administratively insolvent.

In re Commissary Operations, Inc.,
421 B.R. 873 (Bankr. M.D. Tenn. 2010)

As set forth more fully in the last issue of the Avoidance Action Report, in *In re Commissary Operations, Inc.*, the Debtor brought avoidance actions against creditors that also held Section 503(b)(9) claims. The Debtor moved for declaratory judgment that such shipments could not be used for a new value defense, because it would permit the Defendants to "double dip" by receiving payment on the administrative expense claim and reduce liability in a preference action.

The Bankruptcy Court ruled in favor of the creditors, reasoning that there is nothing in the plain language of Section 503(b)(9) or Section 547(c)(4) to indicate that the two sections are mutually exclusive. The Court stated that the "preference window" closed on the date the Debtor filed its bankruptcy petition and "postpetition payments [on Section 503(b)(9) claims] could not be used to deplete prepetition 'new value.'" It also reasoned that requiring suppliers to choose between an administrative expense claim and the new value defense would negate the benefits that Congress intended to confer upon businesses that ship goods to troubled companies when it enacted the new value defense in the Bankruptcy Code.

Commentary

The Courts' holdings in *In re TI Acquisition, LLC* and *In re Commissary Operations, Inc.* are examples of how bankruptcy courts' efforts to implement Congressional policies designed to incentivize entities to deal with troubled companies, while also promoting equal treatment of creditors, can lead to different results. In determining whether a defendant who received a Section 503(b)(9) claim can also use the goods for which it received such claim as "new value" to reduce preference exposure, practitioners should ascertain how courts in their district and circuit have ruled on this issue.

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