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Column
Last in Line

*29 UNIFORM FRAUDULENT TRANSFER ACT MAKES INSIDER PREFERENCES CREATURES OF STATE LAW

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My home state, Michigan, adopted the Uniform Fraudulent Transfer Act (UFTA), effective Dec. 30, 1998. Thus, I remember well the dynamics of the out-of-court workouts before the UFTA was enacted. Counsel for the troubled business worked hard to keep the creditors at bay, and counsel for the insiders tried to stave off a bankruptcy filing until *after* the expiration of the bankruptcy's one-year preference period for insider preferences. Sound familiar? Well, that scenario is now likely to be obsolete.

Forty states have now adopted the Uniform Fraudulent Transfer Act,[1] and 36 of them adopted it *with* UFTA §5(b), which makes insider preferences recoverable under state law.[2]

Section 5(b) of the UFTA states:

§5. Transfers Fraudulent as to Present Creditors...

> (b) A transfer made by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made if the transfer was made to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent.

On its face, §5(b) is somewhat similar to §547 of the Bankruptcy Code. Both laws target payments made on account of antecedent debt made while the debtor was insolvent. However, the similarity stops there. Indeed, the differences between §5(b) and insider preferences under §547 are probably more important than the similarities. This article focuses on those differences.

1. Does §5(b) have a one-year preference period for insiders? Section § 547(b)(4) of the Bankruptcy Code enables a debtor to recover any preferential transfer that was made to an insider within one year before the bankruptcy filing date. On its face, §5(b) does not contain any preference period, however UFTA §9(c) states as follows:

§9. Extinguishment of Claim for Relief.

A claim for relief with respect to a fraudulent transfer or obligation under this act is extinguished unless action is brought...

(c) under §5(b), within one year after the transfer was made or the obligation was incurred.

At first blush, §9(c) appears to create a one-year preference period just like §547(b)(4). However, §9(c) and the Bankruptcy Code are markedly different. The Bankruptcy Code separates the preference period from the statute of limitations. Section 547(b)(4) targets all preferential transfers made to insiders within one year before the *bankruptcy filing date.* A separate section

of the Bankruptcy Code, namely §546, sets forth the statute of limitations.[3] By contrast, however, §9(c) targets all insider preferences that were made within one year before an action for their retrieval was filed with the court. Thus, §9(c) automatically intertwines the one-year preference period and the one-year "statute of extinguishment." Consequently, a lawsuit to recover an insider preference under §5(b) *must* be filed within one year after the transfer was made or the obligation was incurred. Indeed, the comment to §9 states that its purpose is to "make clear that lapse of the statutory periods described by the section bars the right and not merely the remedy."

***36** *2. Do the UFTA and the Bankruptcy Code define "insider" the same way?* The term "insider" is defined similarly in both UFTA §1(7) and in Bankruptcy Code §101(31) to include a list of persons and entities; however, there are slight differences. For example, the UFTA's definition of "insider" omits the reference to municipalities. If the debtor is an individual, corporation or partnership, the UFTA's definition of "insiders" includes general partners as insiders of the debtor *only if* the debtor is also a general partner in that partnership. By contrast, the Bankruptcy Code defines "insider" to include *all* general partners of the debtor, regardless of whether the debtor is a general partner or a limited partner in that partnership.

Like the Bankruptcy Code, UFTA §1(7)(iv) defines "insider" to include "an affiliate or an insider of the affiliate, as if the affiliate were the debtor." This makes the UFTA particularly useful in those out-of-court workouts involving intercompany "loans" or transfers, and targets them for recovery as insider preferences if they occurred within one year before an action for their recovery is filed.

At least one court construed the word "includes" in §1(7) as a term "of enlargement and not of exclusive enumeration or limitation." *See* Putman, J. Michael, M.D. P.A., *Money Purchase Pension Plan v. Stephenson,* 805 S.W. 2d 16 (Tex. 1991). This is consistent with the comment to the UFTA and with the rules of construction contained in §102(3) of the Bankruptcy Code.

3. Does the UFTA impose strict liability on insiders who receive preferences, or does it target only those insiders who have knowledge of the debtor's insolvency? The biggest difference between §5(b) and §547 is that the former requires the insider to have "reasonable cause to believe that the debtor was insolvent" before preference liability will be imposed. However, §547 is a strict liability statute under which preference liability will be imposed irrespective of whether the preference defendant knew about the debtor's insolvency. At least one court has held that the "reasonable cause to believe" standard set forth in §5(b) does not require actual knowledge of insolvency, but instead requires only "knowledge of facts that would cause one to investigate, and which investigation would lead to discovery of insolvency." *See Herald Publishing Co. v. Barberino,* 1993 WL 498798 (Conn. Super. 1993).

4. Do the UFTA and the Bankruptcy Code use the same test for insolvency? Both UFTA §2(a) and Bankruptcy Code §101(32) use a balance sheet test for determining insolvency. Both exclude from the asset side of that balance sheet any property that was transferred, concealed or removed with intent to hinder, delay or defraud creditors. However, the UFTA goes further because it excludes from the balance sheet assets that have been transferred in a *manner* that makes the transfer voidable under the UFTA itself (*see* UFTA §2(d)), and also excludes debts that are secured by a valid lien on property of the debtor if that property is not included as an asset (*see* UFTA §2(e)). Section 101(32) does not explicitly exclude these items from the balance sheet for purposes of insolvency.

Another difference between the UFTA and the Bankruptcy Code lies in the presumption of insolvency. Section 547(f) of the Bankruptcy Code *automatically presumes* that the debtor was insolvent on and during the 90 days before bankruptcy. However, in order to invoke the presumption of insolvency under the §2(b), the creditor has to show that the debtor is not paying debts as they become due. The UFTA contains no automatic presumption of insolvency for any time period.

5. Are there any defenses to insider preferences under the UFTA? UFTA §8(f) contains three statutory defenses to insider preferences:

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§8. Defenses, Liability and Protection of Transferee.

(f) A transfer is not voidable under §5(b):

(1) to the extent that the insider gave new value to or for the benefit of the debtor after the transfer was made unless the new value was secured by a valid lien;

(2) if made in the ordinary course of business or financial affairs of the debtor and the insider; or

(3) if made pursuant to a good-faith effort to rehabilitate the debtor and the transfer secured present value given for that purpose as well as an antecedent debt of the debtor.
The subsequent "new value" defense contained in §8(f)(1) was obviously derived from §547(c)(4). Indeed, §8(f)(1) is much easier to understand than §547(c)(4). Like the new value defense under the Bankruptcy Code, §8(f)(1) provides a defense only to the extent of new value given *after* the transfer was made. At least one court has held that the "subsequent new value" defense in §8(f)(1) does not apply if the new value was given at the same time as a preferential transfer was made. *See Prairie Lakes Health Care System v. Wookey*, 583 N.W. 2d 405 (S.D. 1998). Also, under §8(f)(1) the subsequent new value given must not be secured by a valid lien, because any such lien would diminish the estate and would therefore result in an insider preference. However, the comments to § 8(f)(1) clarify that if the lien taken to secure the new value is itself voidable, then the new value is not secured by a valid lien and it is therefore eligible to be used as a defense to an insider preference.

The "ordinary business" defense contained in §8(f)(2) is obviously derived from §547(c)(2). Indeed, it is virtually identical to §547(c)(2)(B), but omits the first and third prongs of the Bankruptcy Code's ordinary business defense. Consequently, a preference defendant under the UFTA does not need to prove that the transfer was made in payment of a debt incurred by the debtor in the ordinary course of business, or that it was made according to ordinary business terms. *Prairie Lakes Health Care System v. Wookey*, 583 N.W. 2d 405 (S.D. 1998). Instead, under the UFTA's ordinary business defense, the preference defendant need only show that the transfer was part of the ordinary course of dealing between the insider and the debtor.

The defense contained in §8(f)(3) has no counterpart in the Bankruptcy Code. According to the comments, the drafters of the UFTA believed that an insider who had already extended credit to a debtor should be encouraged to extend additional credit in a good faith effort to rehabilitate the debtor, even if the insider takes a security interest in the debtor's assets in exchange. Consequently, §8(f)(3) provides that an insider can invoke this defense if, in good faith, he or she infuses present value into an insolvent debtor and takes a security interest to secure that present infusion *and* any antecedent obligation that the debtor may owe to the insider. "Good faith" is to be determined by analyzing factors such as ***37** the amount of the present value given, the size of the antecedent debt secured, and the likelihood that the debtor will actually be rehabilitated. *See Prairie Lakes Health Care System v. Wookey*, 583 N.W. 2d 405 (S.D. 1998), and comment to §8(f)(3).

In addition, §8(e) provides two other defenses that can be used by insider preference defendants (as well as other defendants under the UFTA) as follows:
(e) A transfer is not voidable under §4(a)(2) or §5 if the transfer results from:

(1) termination of a lease upon default by the debtor when the termination is pursuant to the lease and applicable law; or

(2) enforcement of a security interest in compliance with Article 9 of the Uniform Commercial Code.

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Conclusion

Section 5(b) of the UFTA is different from §547 of the Bankruptcy Code in several important ways. While §5(b) targets only insiders, §547 targets everybody who received a preferential transfer during the preference period. Indeed, perhaps the UFTA's focus on insiders represents a legislative opinion that §547 simply casts too wide a net and inappropriately transforms the cooperative trade creditor into a preference defendant. While the UFTA contains fewer preference defenses than the Bankruptcy Code, the preference defenses under the UFTA are easier to prove. In addition, the "rehabilitation of the debtor" defense contained in §8(f)(3) is a new defense that rewards and protects the insider's efforts to infuse new capital to rehabilitate the debtor, even if the insider takes a lien on the debtor's assets to secure that present value as well as other antecedent debt. In short, from the creditor's point of view, the remedy under §5(b) is far more limited than it is under the Bankruptcy Code.

Nevertheless, the UFTA has forever changed the dynamics of out-of-court workouts because it provides creditors with important negotiating leverage. Creditors no longer have to be subjected to or threatened with an expensive bankruptcy proceeding in order to pursue insider preferences. Indeed, under the UFTA, an *individual* creditor can pursue recovery of insider preferences. Thanks to the UFTA, insiders in 36 states (and the preferences that they received) are now squarely within the creditors' cross-hairs--even in an out-of-court workout.

Footnotes

1 The following 40 states have adopted the Uniform Fraudulent Transfer Act: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Maine, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Dakota, Texas, Utah, Vermont, Washington, West Virginia and Wisconsin.

2 Of the 40 states that adopted the Uniform Fraudulent Transfer Act, four states, namely Arizona, California, Indiana and Pennsylvania, omitted § 5(b). Consequently, insider preferences are not creatures of state law in those four jurisdictions.

3 Under §546(a) of the Bankruptcy Code, the statute of limitations for filing a preference action under §547 is the earlier of: (1) the later of (A) two years after the entry of the order for relief, or (B) one year after the appointment or election of the first trustee under §702, 1104, 1163, 1202 or 1302 of this title if such appointment or such election occurs before the expiration of the period specified in subparagraph (A), or (2) the time the case is closed or dismissed.

18-SEP AMBKRIJ 29

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