

2009 ABI Northeast Conference

Fraud Panel

Troubling Economy brings desperate measures from some companies. Whether intentional or deliberate, more fraud occurs and is revealed during troubled times.

Common forms of fraud:

- Pre-billing of or fraudulent invoices/accounts
- Fraudulent inventory purchases
- Ponzi schemes
- Diversion of Assets
- Misstated Financial Records

Fraud “losers”:

- Lenders
- Investors
- Unsecured creditors

Who are the perpetrators?

- Business Owners/Insiders
- CFO’s
- Subsequent Transferees

What are the signs of fraud?

- Inconsistent financial statements/Books and Records
- Large swings in accounts receivable, inventory and or accounts payable
- Overadvances on debt
- Non-recorded mortgages
- Complex corporate structures coupled with intercompany transactions

What are the next steps?

- Bankruptcy filings
- Removal of perpetrator from company
- Liquidation
- Restructuring

FRAUD¹

During troubled economics times, where there is a lack of financial prosperity, the absence of abundant cash and financing makes it more difficult to mask impropriety, ultimately resulting in uncovering more fraud. As Warren Buffet once said, “It’s when the tide goes out that you find out who has been swimming naked.” During a troubled economy, investors may be more critical and observant about their investments and, generally, have more liquidity needs than otherwise. Some of the types of fraud exposed during these times include, among others:

- Pre-billing or fraudulent invoicing of account – recognition of false income;
- Fraudulent inventory purchases – false inflation of assets on the balance sheet;
- Ponzi schemes – payment of returns to previous investors from later-acquired funds;
- Diversion of assets – illegal transfer of assets; and
- Misstated financial records – falsification of records concerning financial health.

These frauds are perpetrated on public and private entities by business owners, insiders, financial officers and subsequent transferees and result in significant losses to lenders, unsecured creditors and investors. Signs of fraud include:

- Inconsistent financial statements, books and records;
- Large swings in accounts receivable, inventory and/or accounts payable;
- Overadvances of debt;
- Non-recorded liens;
- Complex financial structures coupled with significant inter-company transfers;
- Financial statements prepared by small or unknown auditors;
- Opaque and non-responses to inquiries concerning hard data on assets and liabilities; and
- Unrealistic guaranteed returns;

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Upon discovery of fraud, a number of tools exist to combat and unwind the fraud, salvage any viable assets and prosecute collection efforts to benefit victims. Under state and federal law, receivers may be appointed upon motion by creditors, parties-in-interest, and/or state or federal government. In many cases, whether voluntary by the receiver or the entity or involuntary by creditors, these fraud cases end up in bankruptcy, which provide various tools to aid the fiduciary and government.

RECEIVERS

Historically, the receiver was appointed by a court of equity to protect and preserve property subject to court proceedings. Modern receivers may be temporary or permanent and are classified as equity receivers or statutory receivers. Equity receivers are specially appointed by the courts to take control, custody or management of property, that is involved in or is likely to become involved in litigation, so as to preserve such property pending final disposition in the suit. Statutory receivers are provided by specific statutes, which prescribe the scope of their authority.

The appointment of a receiver is generally considered a drastic remedy imposed where no lesser relief will be effective. Ferguson v. Tabah, 288 F.2d 655 (2nd Cir. 1961). In determining the appointment of a receiver, courts consider numerous factors including: (i) fraudulent conduct on the part of the defendant; (ii) imminent danger that property will be lost or squandered; (iii) inadequacy of available legal remedies; (iv) probability that harm to plaintiff by denial of appointment would be greater than injury to parties opposing appointment; (v) plaintiff's probable success in action and possibility of irreparable injury to its interests in property; and (vi) whether interests of plaintiff and other sought to be protected will in fact be well served by receivership. Versames v. Palazzolo, 96 F. Supp. 2d 361 (S.D.N.Y. 2000); see also Comcoach Corp. v. Roslyn Savings Bank, 19 B.R. 231, 234-35 (Bankr. S.D.N.Y. 1982) (appropriate to

appoint receiver where a debtor is failing to collect rents); Chaline Estates, Inc. v. Furcraft Assoc., 278 A.D.2d 141, 142 (1st Dept. 2000) (appropriate to appoint receiver where the defendant “manifests a predisposition to take unilateral action in disregard of plaintiff’s rights”); LeFebvre v. Shea, 212 A.D.2d 884, 885 (3d Dept. 1995) (appropriate to appoint receiver before service of summons where there is danger of the property being removed from the state, lost, injured or destroyed); Meurer v. Meurer, 21 A.D.2d 778 (1st Dept. 1964) (appropriate to appoint receiver where there are specific moneys at issue).

Receivers are appointed in Federal diversity cases, including:

- Foreclosure actions, F.D.I.C. v. Vernon Real Estate Investments, Ltd., 798 F. Supp. 1009 (S.D.N.Y. 1992);
- Rent skimming schemes, Republic of the Philippines v. Marcos, 653 F. Supp. 494 (S.D.N.Y. 1987);
- Protecting judgment creditors, World Fuel Serv. Corp. v. Moorhead, 229 F. Supp. 2d 584 (N.D. Tex. 2002).

In Federal issue cases, receivers are appointed in:

- RICO actions, U.S. v. Ianniello, 824 F.2d 203 (2nd Cir. 1987) (appointing a receiver after discovery to prevent the skimming of profits during the pendency of the litigation);
- Federal and/or state government, under federal securities, trade, and civil forfeiture statutes.

BANKRUPTCY

If a bankruptcy case under chapter 11 is commenced (or converted from an involuntary chapter 7 case) or the purported debtor is in the gap period between the filing of an involuntary case and the issuance of the order for relief, the entity’s management remains in control under sections 1107 and 1108 of the Bankruptcy Code.² Since this management may be either

² Section 303 of the Bankruptcy Code authorizes the commencement of a chapter 7 or 11 proceeding by three or more creditors (if the debtor has 12 or more creditors in total) or one or more creditors (if the debtor has less than 12

complicit in the debtor's fraud or incompetent, parties may seek the appointment of a trustee. In 2005, Congress amended the Bankruptcy Code to mandate the U.S. Trustee (the bankruptcy watchdog) to apply for the appointment of a trustee under certain circumstances.³

Once a bankruptcy proceeding has commenced (and control of the case is out of the hands of any wrong-doers), there are a number of tools available under the Bankruptcy Code and state law to assist in the maximization and liquidation of the estate, including actions for turnover, recovery of assets held by alter egos of the debtor, imposition of constructive trusts, avoidance and recovery of recovery of preferential transfers, avoidance and recovery of fraudulent transfers, claim subordination, other causes of action under state law, and bankruptcy crimes.

Appointment Of A Trustee

Section 1104 applies regarding the appointment of a trustee in a chapter 11 proceeding (in chapter 7, a trustee is automatically appointed) and provides:

- (a) At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of a trustee—
 - (1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor;

creditors in total) who hold unsecured claims in the aggregate amount of at least \$13,475 that are not contingent (e.g. guarantees) and are not subject to *bona fide* dispute by the debtor.

³ Section 1104(e) of the Bankruptcy Code provides:

The United States trustee shall move for the appointment of a trustee under subsection (a) if there are reasonable grounds to suspect that current members of the governing body of the debtor, the debtor's chief executive or chief financial officer, or members of the governing body who selected the debtor's chief executive or chief financial officer, participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting.

11 U.S.C. § 1104(e).

(2) if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor; or

(3) if grounds exist to convert or dismiss the case under section 1112, but the court determines that the appointment of a trustee or an examiner is in the best interests of creditors and the estate.

11 U.S.C. § 1104(a). Section 1112(b)(1) authorizes the bankruptcy court to convert a chapter 11 case to a case under chapter 7 or dismiss a chapter 11 case for “cause,” which cause may also constitute grounds for the appointment of a chapter 11 trustee if such is in the best interest of creditors. “Cause” under section 1112 of the Bankruptcy Code is defined to include:

(A) substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation;

(B) gross mismanagement of the estate;

(C) failure to maintain appropriate insurance that poses a risk to the estate or to the public;

(D) unauthorized use of cash collateral substantially harmful to 1 or more creditors;

(E) failure to comply with an order of the court;

(F) unexcused failure to satisfy timely any filing or reporting requirement established by this title or by any rule applicable to a case under this chapter;

(G) failure to attend the meeting of creditors convened under section 341 (a) or an examination ordered under rule 2004 of the Federal Rules of Bankruptcy Procedure without good cause shown by the debtor;

(H) failure timely to provide information or attend meetings reasonably requested by the United States trustee (or the bankruptcy administrator, if any);

(I) failure timely to pay taxes owed after the date of the order for relief or to file tax returns due after the date of the order for relief;

(J) failure to file a disclosure statement, or to file or confirm a plan, within the time fixed by this title or by order of the court;

(K) failure to pay any fees or charges required under chapter 123 of title 28;

(L) revocation of an order of confirmation under section 1144;

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(M) inability to effectuate substantial consummation of a confirmed plan;

(N) material default by the debtor with respect to a confirmed plan;

(O) termination of a confirmed plan by reason of the occurrence of a condition specified in the plan; and

(P) failure of the debtor to pay any domestic support obligation that first becomes payable after the date of the filing of the petition.

11 U.S.C. § 1112(b)(4).⁴

Section 1104(a)(1)

If the bankruptcy court determines that cause exists under section 1104(a)(1), then it must appoint a trustee. See Morgenstern v. Revco D.S., Inc. (In re Revco D.S., Inc.), 898 F.2d 498, 501 (6th Cir. 1990); In re Sharon Steel Corp., 871 F.2d 1217, 1226 *3d Cir. 1989); Midatlantic Nat'l Bank v. Anchorage Boat Sales, Inc. (In re Anchorage Boat Sales, Inc.), 4 B.R.635, 644 (Bankr. E.D.N.Y. 1980).

Section 1104(a)(1) enumerates fraud, dishonesty, incompetence or gross mismanagement either before or after the commencement of the case as a non-exclusive list for cause. Other factors that courts have considered for cause include: conflicts of interest, inappropriate relationships between corporate parents and subsidiaries, misuse of assets and funds, inadequate record keeping and reporting, conduct found to establish fraud or dishonesty, lack of credibility

⁴ In addition, section 1104(c) mandates the appointment of an examiner under certain conditions:

(c) If the court does not order the appointment of a trustee under this section, then at any time before the confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of an examiner to conduct such an investigation of the debtor as is appropriate, including an investigation of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor of or by current or former management of the debtor, if-

- (1) such appointment is in the interests of creditors, any equity security holders, and other interests of the estate; or
- (2) the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed \$5,000,000.

11 U.S.C. § 1104(c). Even if the court does not feel it is appropriate to appoint a trustee, it must appoint an examiner upon request (so long as the debt requirement is satisfied).

and creditor confidence, and breach of fiduciary duty. In re Marvel Entertainment Group, Inc., 140 F.3d 463, 472 (3d Cir. 1998); Oklahoma Refining v. Blaik (In re Oklahoma Refining), 838 F.2d 1133, 1136 (10th Cir. 1988); In re PRS Insurance, 274 B.R. 381, 385 (Bankr. D. Del. 2001); In re Intercat, Inc., 247 B.R. 911, 922 (Bankr. S.D. Ga. 2000); In re Clinton Centrifuge, Inc., 185 B.R. 980, 985 (Bankr. 1995); In re Rivermeadows Associates, Ltd., 185 B.R. 615 (Bankr. D. Wyo. 1995); Petit v. New England Mortgage Services, Inc., 182 B.R. 64, 70 (Bankr. Me. 1995); In re Bellevue Place Assocs., 171 B.R. 615, 613-25 (Bankr. N.D. Ill. 1994); North American Communications, Inc., 138 B.R. 175, 179 (Bankr. W.D. Pa. 1992); U.S. Communications of Westchester Inc., 123 B.R. 491, 495-96 (Bankr. S.D.N.Y. 1991); In re Cardinal Indus., Inc., 109 B.R. 755, 765 (Bankr. S.D. Ohio 1990); In re Microwave Prods. Of Am. Inc., 102 B.R. 666 (Bankr. W.D. Tenn. 1989); In re Sharon Steel Corp., 86 B.R. 455, 457 (Bankr. W.D. Pa. 1988); In re Colby Const. Corp., 51 B.R. 113 (Bankr. S.D.N.Y. 1985); In re William H. Vaughan & Co., 40 B.R. 524, 526 (Bankr. E.D. Pa. 1984); In re Brown, 31 B.R. 583, 585 (Bankr. D. Colo. 1983); In re Bonded Mailings, Inc., 20 B.R. 781, 786 (Bankr. E.D.N.Y. 1982); In re Main Line Motors, Inc., 9 B.R. 782, 784 (Bankr. E.D. Pa. 1981); Midatlantic Nat'l Bank v. Anchorage Boat Sales, Inc. (In re Anchorage Boat Sales, Inc.), 4 B.R.635, 644 (Bankr. E.D.N.Y. 1980); Dardarian v. La Sherene, Inc. (In re La Sherene, Inc.), 3 B.R. 169, 176 (Bankr. N.D. Ga. 1980).

Section 1104(a)(2)

Section 1104(a)(2) of the Bankruptcy Code grants the bankruptcy court broad discretion to appoint a trustee despite the absence of “cause,” provided such appointment is in the interests of creditors. Bankruptcy courts have identified four factors for consideration in the appointment of a trustee in the best interests of creditors: “(i) the trustworthiness of the debtor; (ii) the debtor in possession’s past and present performance and prospects for the debtor’s reorganization [or rehabilitation]; (iii) the confidence – or lack thereof – of the business community and of creditors

in present management; (iv) the benefits derived by the appointment of a trustee, balanced against the costs of appointment.” In re Colorado-Ute Elec. Ass’n, Inc., 120 B.R. 164, 176 (Bankr. D. Colo. 1990); see also In re Euro-American Lodging Corp., 365 B.R. 421, 427 (Bankr. S.D.N.Y. 2007); In re Ionosphere Clubs, Inc., 113 B.R. 164, 168 (Bankr. S.D.N.Y. 1990) (citations omitted).

Section 1104(a)(3)

Section 1104(a)(3) of the Bankruptcy Code provides that “cause” for the conversion of the case to a case under chapter 7 constitutes grounds for the appointment of a trustee if the bankruptcy court determines that a trustee in lieu of conversion is in the best interests of creditors and the estate. Courts have held that factors warranting conversion also support the appointment of a trustee. In re U.S. Truck Co., Inc., 44 B.R. 311 (D. Mich. 1984); In re NVF Communications Corp., 41 B.R. 546 (Bankr. D.D.C. 1984). Moreover, many of the additional factors that bankruptcy courts have determined to support the appointment of a trustee as set forth above also constitute factors for cause for conversion.

Turnover Powers

The turnover provisions of the Bankruptcy Code are contained in sections 542 and 543. Section 542 requires turnover of property of the estate to the trustee, except property which the individual debtor may exempt or property in the possession, custody or control of a custodian (defined as a trustee, assignee for the benefit of creditors, receiver or similar official under section 101(11) of the Bankruptcy Code). Section 542(e) provides the trustee with a powerful tool to acquire financial information regarding the debtor.

Subject to any applicable privilege, after notice and a hearing, the court may order an attorney, accountant, or other person that holds recorded information, including books, documents, records, and papers, relating to the debtor’s property or financial affairs, to turn over or disclose such recorded information to the trustee.

11 U.S.C. § 542(e). Subject to certain exceptions, section 543 of the Bankruptcy Code requires a custodian to turn over to the trustee property of the debtor in its possession, custody or control, or proceeds, product, offspring, rents or profits of such property, that is in the custodian's possession, custody or control on the date the custodian acquires knowledge of the commencement of the bankruptcy case and file an accounting with the court.

Alter Egos

Bankruptcy courts have the power to direct the turn over to the trustee of assets of a debtor's alter ego(s). In doing so, bankruptcy courts apply state law alter ego or veil piercing theories to expand the scope of property within property of the debtor's estate under section 541 of the Bankruptcy Code.⁵

⁵ Property of the debtor's estate is defined to include all the following property, wherever located and by whomever held:

- (1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.
- (2) All interests of the debtor and the debtor's spouse in community property as of the commencement of the case that is—
 - (A) under the sole, equal, or joint management and control of the debtor; or
 - (B) liable for an allowable claim against the debtor, or for both an allowable claim against the debtor and an allowable claim against the debtor's spouse, to the extent that such interest is so liable.
- (3) Any interest in property that the trustee recovers under section 329 (b), 363 (n), 543, 550, 553, or 723 of this title.
- (4) Any interest in property preserved for the benefit of or ordered transferred to the estate under section 510 (c) or 551 of this title.
- (5) Any interest in property that would have been property of the estate if such interest had been an interest of the debtor on the date of the filing of the petition, and that the debtor acquires or becomes entitled to acquire within 180 days after such date—
 - (A) by bequest, devise, or inheritance;
 - (B) as a result of a property settlement agreement with the debtor's spouse, or of an interlocutory or final divorce decree; or
 - (C) as a beneficiary of a life insurance policy or of a death benefit plan.
- (6) Proceeds, product, offspring, rents, or profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case.
- (7) Any interest in property that the estate acquires after the commencement of the case.

11 U.S.C. § 541(a). Section 541 of the Bankruptcy Code provides a expansive definition of property of the estate. U.S. v. Whiting Pools, Inc., 462 U.S. 198, 203 (1983). Property interests are created and defined by state law, and such interests are not analyzed differently merely because a party has filed for bankruptcy protection. Louisiana World Exposition v. Fed. Ins. Co., 858 F.2d 233, 252 (5th Cir. 1998); In re Cannon, 277 F.3d 838, 853-54 (6th Cir. 2002).

Various factors are considered in determining whether an entity may be considered an alter ego, which include:

- Transfers between corporations for their own convenience and advantage;
- Presence or absence of consolidated business or financial records;
- Unity of interests and ownership;
- Existence of inter-entity transactions;
- Existence of transfers of assets without observance of corporate or other legal formalities or for inadequate consideration;
- Non-functioning of other officers and directors;
- Absence of corporate records;
- Dominion by shareholder(s);
- Siphoning of funds and/or assets;
- Payment by one entity of obligations of other; and
- Commonality of directors and officers.

Courts have pierced the corporate veil where there is a showing that the owner exercised complete dominion over the entity, and such domination was used to perpetrate fraud resulting in injuries to creditors. See Morris v. Department of Taxation and Finance, 82 N.Y.2d 135, 603 N.Y.S.2d 807, 810-11 (1993).

By piercing the corporate veil, the assets of the alter ego entity become assets of the debtor and, thus, property of the debtor's estate. Such assets are subject to the above described turn over provisions under sections 542 and 543 of the Bankruptcy Code.

Constructive Trust

The ultimate purpose of a constructive trust is to prevent unjust enrichment and thus, one may be imposed when the property has been acquired in such circumstances that the holder of legal title may not in good conscience retain the beneficial interest. Cruz v. McAneney, 31

A.D.3d 54, 58-59 (2nd Dept. 2006). A constructive trust is a remedy used to correct some act of fraud or breach of duty or confidence and is intended to be fraud-rectifying (not intent-enforcing) by preventing one who failed to meet an obligation or committed fraud or other misconduct from becoming unjustly enriched. In re First Central Financial Corp., 377 F.3d 209, 216 – 18 (2nd Cir. 2004); Simonds v. Simonds, 58 A.D.2d 305, 309-10 (4th Dept. 1977).

A constructive trust is a remedial device of equity. In other words “[a] constructive trust is the formula through which the conscience of equity finds expression. When property has been acquired in such circumstances that the holder of the legal title may not in good conscience retain the beneficial interest equity converts him into a trustee.” Stewart v. Harris Structural Steel Co., Inc., 198 N.J. Super. 255, 266, 486 A.2d 1265 (App.Div.1984) (quoting Beatty v. Guggenheim Exploration Co., 225 N.Y. 380, 386, 122 N.E. 378 (1919) (Cardozo, J.)).

Securities and Exchange Commission v. Antar, 120 F. Supp. 2d 431, 447 (D.N.J. 2000); see also Thompson v. City of Atlantic City, 901 A.2d 428, 438-39 (N.J. Super. Ct. App. Div. 2006).

The usual elements of a constructive trust are: (1) a confidential or fiduciary relationship⁶; (2) a promise by the trustee to hold the property for the beneficiary’s advantage, express or implied; (3) transfer of the property in reliance thereon; and (4) unjust enrichment of the trustee absent a constructive trust. In re Ades and Berg Group Investors, 550 F.3d 240, 245 (2nd Cir. 2008); Cruz v. McAneney, 31 A.D.3d 54, 59 (2nd Dept. 2006); First Federal Sav. And Loan Ass’n of Rochester v. Kasmer, 140 A.D.2d 826, 828 (3rd Dept. 1988); Scull v. Scull, 94 A.D.2d 29, 33 (1st Dept. 1983).

Unjust enrichment results when a person retains a benefit which, under the circumstances of the transfer and considering the relationship of the parties, it would be inequitable to retain. Counihan v. Allstate Ins. Co., 194 F.3d 357, 361 (2nd Cir. 1999). The elements for unjust

⁶ A familial relationship will normally satisfy this element. Dobbs v. Dobbs, 2008 WL 3843528, at *10 (S.D.N.Y. 2008).

enrichment are: (1) the other party was enriched; (2) at that party's expense; and (3) that it is against equity and good conscience to permit the other party to retain what is sought to be recovered. In re Bennett Funding Group, Inc., 2007 WL 2042498, at *4 (N.D.N.Y. 2007); Cruz v. McAneney, 31 A.D.3d 54, 59 (2nd Dept. 2006).

Unjust enrichment is at the heart of the constructive trust doctrine. Bolla v. Bolla, 10 Misc.3d 906, 911 (N.Y. Sur. 2005). The conclusion that one has been unjustly enriched is essentially a legal inference drawn from the circumstances surrounding the transfer of property and the relationship of the parties. Continental Cas. Co. v. State of New York Mortgage Agency, 1998 WL 513054, *13 (S.D.N.Y. 1998). Unjust enrichment does not require a wrongful act committed by the one enriched and innocent parties may frequently be unjustly enriched. Cruz v. McAneney, 31 A.D.3d 54, 59 (2nd Dept. 2006).

The above four elements for the imposition of a constructive trust are considered important guideposts that are applied flexibly. In re Koreag, Controle et Revision S.A., 961 F.2d 341, 352 (2nd Cir. 1992). Courts can and will impose constructive trusts whenever necessary to satisfy the demands of justice. Cruz v. McAneney, 31 A.D.3d 54, 59 (2nd Dept. 2006). The absence of any one factor will not itself defeat the imposition of a constructive trust when otherwise required by equity. In re Koreag, Controle et Revision S.A., 961 F.2d 341, 353 (2nd Cir. 1992); Counihan v. Allstate Ins. Co., 194 F.3d 357, 362 (2nd Cir. 1999) (applying a constructive trust despite the lack of a transfer of property in reliance on a promise and holding that a "deficiency should not be allowed to spawn an inequitable result"). Rather, all the surrounding circumstances must be analyzed. In re Stylesite Marketing, Inc., 253 B.R. 503, 508 (Bankr. S.D.N.Y. 2000). A constructive trust arises contrary to intention and *in invitum*, against one who, by fraud, actual or constructive, by duress or abuse of confidence, by commission of

wrong, or by any form of unconscionable conduct, artifice, concealment or questionable means, or who in any way against equity and good conscience, either has obtained or holds the legal right to property which he ought not, in equity and good conscience, hold and enjoy. In re Enron Corp., 2003 WL 1571719, at *4 (S.D.N.Y. 2003). This flexibility in applying the doctrine allows a constructive trust to be to be imposed to prevent unjust enrichment under a “wide range of circumstances. In re Enron Corp., 2003 WL 1571719, at *4 (S.D.N.Y. 2003).

Preferences

The avoidance of preferences is an action unique to the Bankruptcy Code and designed solely to redistribute assets more equitably among the creditors. Section 547 of the Bankruptcy Code defines a preference as a transfer of the debtor’s property (to or for the benefit of a creditor for or on account of an antecedent debt , made while the debtor is insolvent,⁷ within 90 days before the filing of the bankruptcy petition (or within one year before if the transfer was to an “insider”), the net effect of which allows the transferee to receive more than it would have received in a chapter 7 distribution. 11 U.S.C. §547(b). An “insider” is defined under the Bankruptcy Code to include:

(A) if the debtor is an individual – (i) relative of the debtor or of a general partner of the debtor; (ii) partnership in which the debtor is a general partner; (iii) general partner of the debtor; or (iv) corporation of which the debtor is a director, officer, or person in control;

(B) if the debtor is a corporation – (i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor; (iv) partnership in which the debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer, or person in control of the debtor;

(C) if the debtor is a partnership – (i) general partner in the debtor; (ii) relative of a general partner in, general partner of, or person in control of the debtor; (iii) partnership in which the debtor is a general partner; (iv) general partner of the debtor; or (v) person in control of the debtor;

⁷ There is a presumption of insolvency for the 90 days preceding the filing of the petition. 11 U.S.C. § 547(f).

(D) if the debtor is a municipality, elected official of the debtor or relative of an elected official of the debtor;

(E) affiliate, or insider of an affiliate as if such affiliate were the debtor; and

(F) managing agent of the debtor.

11 U.S.C. § 101(31).⁸ Since this list of “insiders” is not exclusive, courts have developed the concept of the “nonstatutory insider” to include a person/entity that does not fall neatly into the statutory list. Recently, in Schubert v. Lucent Techs. Inc. (In re Winstar Comm’ns. Inc.), 554 F.3d 382 (3d Cir. 2009), the court held a creditor that improperly manipulates the debtor to be an insider, subjecting such creditor to preference avoidance for the full year look back period.

Fraudulent Transfers

The three main sources of fraudulent transfer law are: (i) section 548 of the Bankruptcy Code; (ii) the Uniform Fraudulent Conveyance Act (“UFCA”); and (iii) the Uniform Fraudulent Transfer Act (“UFTA”), which was drafted to replace the UFCA. There is very little substantive

⁸ Under the Bankruptcy Code:

The term “affiliate” means—

(A) entity that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor, other than an entity that holds such securities—

(i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or

(ii) solely to secure a debt, if such entity has not in fact exercised such power to vote;

(B) corporation 20 percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by the debtor, or by an entity that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor, other than an entity that holds such securities—

(i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or

(ii) solely to secure a debt, if such entity has not in fact exercised such power to vote;

(C) person whose business is operated under a lease or operating agreement by a debtor, or person substantially all of whose property is operated under an operating agreement with the debtor; or

(D) entity that operates the business or substantially all of the property of the debtor under a lease or operating agreement.

11 U.S.C. § 101(2).

difference between section 548, the UFCA and the UFTA. The bankruptcy trustee is authorized to bring suit under section 548 and applicable state law.⁹

Under each of the above three statutes, there are provisions for the avoidance of transfers that constitute constructive fraud and actual fraud. Under both constructive and actual fraud, the trustee must prove that the debtor had an interest in the property or funds transferred.

Thereafter, constructive fraud requires the trustee to prove that:

- (i) the transfer was made for less than reasonably equivalent or fair consideration; and
- (ii) either (a) the debtor was insolvent when the transfer was made, (b) the debtor was engaged in a business for which the property retained was an unreasonably small capital, or (c) the debtor intended or believed that it would incur debts beyond its ability to pay such debts as they matured.

The actual fraud theory, however, requires the trustee to prove only one additional element – that the transfer was made with the actual intent to hinder delay or defraud the debtor’s creditors. Except in cases where there is criminal fraud convictions, trustees commonly will employ the constructive fraud theory because it is generally easier to establish insolvency and less than reasonably equivalent value than actual intent to hinder, delay and defraud creditors. Courts have found that intent to defraud is rarely gleaned by direct evidence; rather, it is found by inferences of fraudulent intent. Thus, circumstantial evidence may be used in determining whether actual fraudulent intent exists. The factors that courts weigh in determining whether actual intent exists have been termed the “badges of fraud,” some examples of which include:

- The lack or inadequacy of consideration;
- The family, friendship or close associate relationship between the parties;

⁹ Section 544(b) of the Bankruptcy Code provides that “the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim. . . .” 11 U.S.C. § 544(b)(1).

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- The retention or possession, benefit or use of the property in question;
- The financial condition of the party sought to be charged before and after the transaction in question;
- The existence or cumulative effect of a pattern or series of transactions or course of conduct after the incurring of debt, onset of financial difficulties, or pendency or singular threat of suits by creditors; and
- The general chronology of the events and transactions under inquiry.

In re Kaiser, 722 F.2d 1574, 1582-83 (2d Cir. 1938); Max Sugarman Funeral Homes, Inc. v. A.D.D. Investors, 926 F.2d 1248 (1st Cir. 1991) (recognizing similar indicia of fraud).

Section 550 of the Bankruptcy Code separates the concepts of avoidance of a transfer and recovery from the transferee thereof. Where a transfer is avoided, the trustee may recover the property transferred of the value of such property from (i) the initial transferee thereof or (ii) any immediate or mediate transferee of the initial transferee. Bankruptcy Code section 550(a) provides:

Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553 (b), or 724 (a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from—

- (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.

11 U.S.C. § 550(a). Section 550, thereafter, enumerates exceptions to this sections broad reach, including subsequent transferees that gave value in good faith and without knowledge of the voidability of the transfer. In addition, to the extent that a good faith transferee made improvements (which includes preservation costs) to the property after the transfer, such transferee is protected by a lien on the transferred property for the lesser of (i) the costs of improvement or (ii) the increase in the value of the property resulting from those improvements.

Claim Subordination

Section 510(c) of the Bankruptcy Code “adopts the long-standing judicially developed doctrine of equitable subordination under which a bankruptcy court has power to subordinate claims against the debtor’s estate to claims it finds ethically superior under the circumstances.” Allied E. States Maint. Corp., et al. v. Miller (In re Lemco Gypsum, Inc.), 911 F.2d 1553, 1556 (11th Cir. 1990) (citations omitted).¹⁰ To apply equitable subordination, the following three elements must be satisfied (1) the claimant must have engaged in some type of inequitable conduct, (2) the misconduct must have resulted in injury to the creditors or conferred an unfair advantage on the claimant, and (3) equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Code. Benjamin v. Diamond (In re Mobile Steel Co.), 563 F.2d 692, 700 (5th Cir. 1977) (citations omitted). This three-prong test set forth in Mobile Steel, a proceeding under Chapter XI of the Bankruptcy Act, 11 U.S.C. §§ 701 et seq. (1970), has been used in the context of applying the equitable subordination doctrine under the Bankruptcy Code. See Official Comm. of Unsecured Creditors v. Morgan Stanley & Co., Inc., et al. (In re Sunbeam Corp.), 284 B.R. 355, 363 (Bankr. S.D.N.Y. 2002). Under this test, equitable subordination applies to the extent necessary to remedy the otherwise uncompensated harm or unfair advantage. Sunbeam, 284 B.R. at 363.

In addition, “bankruptcy courts are empowered to subordinate claims where the subordination will promote a just and equitable distribution of the bankruptcy estate.” Trone v.

¹⁰ Section 510(c) of the Bankruptcy Code provides:

- Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—
- (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
 - (2) order that any lien securing such a subordinated claim be transferred to the estate.

11 U.S.C. § 510(c).

Smith (In re Westgate-California Corp.), 642 F.2d 1174, 1177 (9th Cir. 1981) (citation omitted). Bankruptcy courts, pursuant to their equitable power, have the authority to subordinate an allowed claim to assure “that fraud will not prevail, that substance will not give way to form, that technical consideration will not prevent substantial justice from being done.” Pepper v. Litton, 308 U.S. 295, 305 (1939). In Pepper v. Litton, the Supreme Court noted that the basis for the rule of equitable subordination is that “the bankruptcy court has the [equitable] power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate.” Pepper v. Litton, 308 U.S. at 308 (citations omitted). The purpose of section 510(c) of the Bankruptcy Code is to correct inequitable conduct and ensure no creditor gain an unfair advantage in the distribution of the estate.

When applying the equitable doctrine, courts will consider other factors, including administrative convenience and the delay of a bankruptcy proceeding. Addison v. Langston (In re Brints Cotton Mktg. Inc.), 737 F.2d 1338, 1341 (5th Cir. 1984). Courts are required to consider administrative convenience and the fundamental principles of equity that creditors of a bankruptcy estate should not be disadvantaged because of the law’s delay. Nicholas v. United States, 384 U.S. 678, 689 (1966).

The power of bankruptcy courts to subordinate allowed claims cannot be used to disregard unambiguous statutory language of the Bankruptcy Code. In United States v. Noland, the Supreme Court held that “. . . the circumstances that prompt a court to order equitable subordination must not occur at the level of policy choice at which Congress itself operated in drafting the Code.” United States v. Noland, 517 U.S. 535, 543 (1996) (citation omitted). The Supreme Court held that “whatever equitable powers remain in the bankruptcy courts must and

can only be exercised within the confines of the Bankruptcy Code.” Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206-07 (1988).

Other Causes of Action

Trustees have standing to pursue causes of action on behalf of the debtor, as such claims constitute property of the debtor’s estate under section 541 of the Bankruptcy Code and subject to administration by the trustee. These claims may include breach of fiduciary duty against and officer or director of the debtor, aiding and abetting fraud or breach of fiduciary duty against third parties and civil RICO. In addition, most states have laws and rules concerning prejudgment writs of attachment or seizure, which are incorporated into Federal Rules of Civil Procedure.

Bankruptcy Crimes

Certain acts in connection with bankruptcy cases constitute a crime under the federal criminal code. Under section 152, it is a crime, subject to a fine and/or imprisonment of up to five years, for any individual who “knowingly and fraudulently”: (1) conceals property of the estate; (2) makes a false oath or account in relation to a bankruptcy case; (3) makes a false declaration, certification, verification or statement in relation to a bankruptcy case; (4) makes a false proof of claim; (5) receives a material amount of property from the debtor with intent to defeat the Bankruptcy Code; (6) gives, offers, receives or attempts to obtain money, property, reward or advantage for acting or forbearing to act in a bankruptcy case; (7) transfers or conceals property with the intent to defeat the Bankruptcy Code; (8) conceals, destroys, mutilates, or falsifies documents relating to the debtor’s property or affairs; (9) withholds documents related to the debtor’s property or financial affairs from a trustee or other court officer. 18 U.S.C. § 152.

Under section 157, similar to the federal mail or wire fraud, provides that a person who, having devised or intending to devise a scheme or artifice to defraud and for purposes of

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executing or concealing such scheme or artifice or attempting to do so (1) files a bankruptcy petition, (2) files a document in a bankruptcy case, or (3) makes a false or fraudulent representation, claim or promise concerning or in relation to a bankruptcy case, including falsely asserting a bankruptcy is pending, is subject to fine and imprisonment of up to five years. 18 U.S.C. § 157.