



## AVOIDANCE ACTION REPORT

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

### 1 Payments Under Forward Contracts, Even Those Without Set Quantities, Not Recoverable As Preferences

### Payments Under Forward Contracts, Even Those Without Set Quantities, Not Recoverable As Preferences

In re MBS Mgmt. Serv., Inc., 690 F.3d 352 (5th Cir. 2012)

In *In re MBS Mgmt. Serv., Inc.*, the trustee for the unsecured creditors' trust sued MXEnergy Electric, Inc. (MXE) to avoid and recover alleged preferential transfers totaling \$156,345.93. The debtor managed apartment complexes for which MXE supplied electricity. The trustee alleged that the debtor's payments to MXE during the 90 days prior to the petition date were avoidable as preferences under Bankruptcy Code section 547. Bankruptcy Code Section 547 allows a trustee or debtor in possession to avoid a transfer made by a debtor while insolvent to or for the benefit of a creditor on account of an antecedent debt within 90 days (or one year in the case of an "insider") of the petition date, where such transfer enables the creditor to receive more than it would have received in a chapter 7 liquidation.

MXE argued that the payments were made pursuant to a forward contract. Under Bankruptcy Code section 546(e), a trustee may not avoid as preferential a payment made under a forward contract. A forward contract is a contract for the purchase, sale, or transfer of a commodity at a future date in order to hedge against price fluctuations. The rationale for this exception is to protect commodity markets from

instability caused by bankruptcy. In response, the trustee argued that MXE was not a proper party to the contract because MXE was the assignee of the contract, which was actually between the debtor and a prior electricity provider. The trustee also argued that the contract was not a true forward contract because it did not specify a set quantity of electricity or contain a specific delivery date. The trustee based this argument on prior case law supporting the notion that mere evidence of recurring payments for a commodity without a specific quantity of product or a delivery date does not fall within the definition of a forward contract. The trustee also reasoned that "ordinary supply contracts" were not intended to be protected from avoidance actions because the rationale for the exception applies only to derivative contracts or those made with pure financial hedging motives, not contracts with end users.

The bankruptcy court for the Eastern District of Louisiana agreed with MXE and found that MXE was the proper party to the contract, because it purchased all of the predecessor entity's assets and both parties continued to perform under the contract terms. The court also found that the payments were made pursuant to a forward contract and were therefore not avoidable. The court held that MXE met the four elements of a forward contract as defined in Bankruptcy Code section 101(25). Bankruptcy Code section 101(25) states that a forward contract is (1) a contract for the sale of a commodity (2) with a delivery date more than two days after execution (3) by a forward contract merchant (someone who creates or manages commodities markets

### 2 Heightened Pleading Standards For Actual Fraud May Be Satisfied By Ponzi Scheme Presumption

### 3 "Ordinary Course Of Business Defense" Must Compare "Preference Period" Transfers To "Historical Period" Transfers When Debtor Was Healthy

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## AVOIDANCE ACTION REPORT

but does not produce commodities) (4) that is not otherwise subject to the rules of a contract board of trade (i.e., a central financial exchange where entities trade and exchange futures contracts). The court found the trustee's argument that the contract needed to contain a specific quantity or a delivery date unconvincing, ruling that a forward contract, as opposed to a futures contract, only requires a specific price per unit. The district court affirmed the bankruptcy court's decision, and the trustee appealed.

The Fifth Circuit affirmed the district court's decision, noting that it previously engaged in an extensive statutory analysis of forward contracts in *In re Olympic Natural Gas*, 294 F.3d 737 (5th Cir. 2002). The court stated that the statutory language concerning forward contracts did not require that they contain a specific quantity or delivery date. Moreover, the court found the trustee's argument that "ordinary supply contracts" should not be protected from preference avoidance unavailing because the statute makes no distinction between ordinary purchase forward contracts (those based on the need for supply) and financial forward contracts (those with pure financial hedging motives). Accordingly, the trustee could not avoid the payments to MXE as preferential.

### COMMENTARY

A creditor who was sued in an avoidance action should evaluate all potential defenses, not just those contained in Bankruptcy Code section 547(c). Section 546(e) provides an absolute defense to suits seeking to avoid forward contract payments. At least in the Fifth Circuit, even contracts without a set quantity

or delivery date are considered forward contracts under the statute. Conversely, debtors in possession and trustees should be mindful of the expanded range of defendants who may avail themselves of this defense when evaluating potential preference claims.

### Heightened Pleading Standards For Actual Fraud May Be Satisfied By Ponzi Scheme Presumption

Zazzali v. 1031 Exch. Grp. LLC, et al. (In re DBSI, Inc.), 476 B.R. 413 (Bankr. D. Del. 2012)

In *Zazzali v. 1031 Exch. Group*, the litigation trustee for the DBSI estate litigation trust sued various defendants under Bankruptcy Code sections 544 and 548 and Idaho law to recover transfers from brokers who received commissions from a company engaging in a Ponzi scheme. Bankruptcy Code section 548 states that a trustee may avoid actual or constructively fraudulent transfers of property of the debtor made within two years prior to the petition date. Section 544 of the Bankruptcy Code allows a trustee to also assert a state law fraudulent transfer claim. Claims for actual fraud allege that the debtor had actual intent to defraud a creditor when making a transfer. Claims for constructive fraud do not require actual fraudulent intent, but, rather, that the debtor received less than reasonably equivalent value for the transfer at a time when the debtor was insolvent or incurring debts beyond its ability to

pay. The defendants moved to dismiss arguing that the plaintiff failed to state a claim.

The trustee alleged that beginning in 2004, the debtors conducted a Ponzi scheme by selling tenant-in-common (TIC) interests through securities and real estate channels. The debtors promised investors a high 6-7% yield on investment and 2-3% annual growth, even though the properties sold were allegedly old and populated with high-credit-risk tenants. To produce the promised returns, the debtors used new investors' money to pay older investors. Thus, the trustee alleged that brokers selling the TIC interests received fraudulent transfers in furtherance of the Ponzi scheme. While allegations of constructive fraud must satisfy general pleading standards under Federal Rule of Civil Procedure 8 (which requires that the complaint state a plausible claim for relief), actual fraud allegations must satisfy the heightened pleading standards of Rule 9(b). Federal Rule of Civil Procedure 9(b) requires a party alleging fraud to state with particularity the circumstances constituting fraud. The trustee argued that the "Ponzi scheme presumption," which assumes all payments made in furtherance of a Ponzi scheme were made with fraudulent intent was sufficient to satisfy Federal Rule of Civil Procedure 9(b). The defendants argued the complaint was deficient because the Ponzi scheme presumption was not sufficient to satisfy Rule 9(b) and because it failed to demonstrate that the specific transfers were made in furtherance of



## AVOIDANCE ACTION REPORT

the Ponzi scheme.

The court denied the defendants' motion to dismiss. The court held that the trustee met the heightened Rule 9(b) pleading standard for actual fraud by adequately pleading facts constituting "badges of fraud," including that the debtors were insolvent at the time of the transfers. The court noted that because hard evidence of actual fraud is difficult to locate, it may look at circumstantial "badges of fraud" to determine whether a party has sufficiently established fraud (badges of fraud include the relationship between the debtor and the transferee, retention of control of the transfer by the debtor, or concealment of the transfer). The court further noted that the trustee's allegation of a Ponzi scheme could qualify as a badge of fraud. Thus, the court found that the trustee sufficiently pled the existence of a Ponzi scheme and that the transfers sought in the complaint were related to or in furtherance of the scheme.

### COMMENTARY

While allegations of fraud under Bankruptcy Section 548 must contain more than a recitation of the elements of fraud, bankruptcy courts are willing to give some leeway to trustees attempting to plead the elements of fraud in connection with a Ponzi scheme. At least in Delaware, trustees need not allege an exhaustive list of badges of fraud in a complaint to survive a motion to dismiss, they must merely allege enough facts to make actual fraud plausible.

### "Ordinary Course Of Business Defense" Must Compare "Preference Period" Transfers To "Historical Period" Transfers When Debtor Was Healthy

Siegel v. Russellville Steel Co. (In re Circuit City Stores, Inc.), 2012 WL 1981781 (Bankr. E.D. Va. June 1, 2012)

In *Siegel v. Russellville Steel Co.*, the trustee of the Circuit City liquidating trust sued Russellville Steel under Bankruptcy Code section 547 to avoid and recover payments the debtor made during the preference period. Bankruptcy Code Section 547 allows a trustee or debtor in possession to avoid a transfer made by a debtor while insolvent to or for the benefit of a creditor on account of an antecedent debt within 90 days (or one year in the case of an "insider") of the petition date, where such transfer enables the creditor to receive more than it would have received in a chapter 7 liquidation. The defendant argued that the payments were not avoidable because they were made in the "ordinary course of business," as they paid invoices in a similar manner to the way the debtor paid invoices within the one year period immediately preceding the preference period (90 days before the bankruptcy filing). Bankruptcy Code section 547(c) states that payments made in the "ordinary course of business" are immune from avoidance. The trustee countered that the appropriate historical period to

use to determine the ordinary course of business is the pre-preference period when the debtors were financially healthy. The trustee argued that if the debtors were experiencing financial difficulty in the period immediately preceding the preference period, the transfers from such period should not be used as a comparison to determine the ordinary course of business.

The debtors, specialty retailers of consumer electronics, filed bankruptcy petitions on November 10, 2008. The debtors bought steel products from the defendant starting in August 2006. In November of 2007, approximately halfway through the parties' course of dealings, the debtors suffered a liquidity crisis causing them to make late payments. Prior to the liquidity crisis, the debtors paid all defendant's invoices between 31-41 days after invoice date, with an average "days to payment" of 33.49 days (not counting certain "outliers"). After the liquidity crisis, the payments increased to 44-51 days from the invoice date, with an average of 46.74 days (excluding certain "outliers"). During the preference period, the debtors paid three invoices at 51, 45, and 46 days after the invoice date, respectively. The defendant conceded that a fourth transfer paying an invoice 189 days after invoice date was not ordinary.

Bankruptcy Code section 547(c)(2) provides that the trustee may not avoid a transfer that was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was — (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or (B) made according to ordinary busi-



## AVOIDANCE ACTION REPORT

ness terms. The defendant did not assert the “objective ordinary course of business” test, which compares the transfers in question with transfers in the debtor’s and defendant’s industries. Rather, the defendant argued that the payments in question were ordinary under the “subjective ordinary course of business” test because they were ordinary as compared to the payments made after November 2007 (which paid invoices 44-51 days after invoice date). The trustee argued that the proper historical period for purposes of the subjective ordinary course of business defense was the period before the liquidity crisis. Thus, the trustee argued that the payments were not ordinary because they were not timely as compared to the historical payments made before the liquidity

crisis (which paid invoices 31-41 days after invoice date).

The bankruptcy court agreed with the trustee. The court determined that the appropriate historical lookback period for this defense should be during a time that the debtor was healthy and, therefore, the appropriate historical baseline consisted of transactions occurring prior to the debtors’ pre-petition “liquidity event,” and did not include historical transactions occurring after the event. Citing *Advo-System Inc. v. Maxway Corp.*, 37 F.3d 1044, (4th Cir. 1994), the court emphasized that the Fourth Circuit test required an analysis of transfers as compared to the *preinsolvency* period, not a comparison to the pre-preference period. Following *Advo-System*, the Court found that all of the

transfers were avoidable because they were not made in the ordinary course of business between the debtors and defendant when comparing the transfers to the debtors’ pre-insolvency period.

### COMMENTARY

Practitioners must be aware that when examining the subjective ordinary course of business defense, the historical period may not always be the one-year or two-year period immediately prior to the preference period. Both the plaintiff and defendant may benefit by arguing that for purposes of the subjective ordinary course of business test, the relevant pre-preference period is the pre-preference when the debtor was healthy.

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