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**I RECEIVED A DEMAND LETTER IN CONNECTION WITH A BANKRUPTCY CASE.
WHAT DO I DO NOW?**

Part Two

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As discussed in my previous legal alert, business owners may occasionally receive a letter from a bankruptcy trustee, liquidating trustee, or Chapter 11 debtor in connection with the bankruptcy of a current or former customer. These letters typically demand the return of payments made by the debtor within a specified period before the bankruptcy filing. In most cases, these demands are based on one of two theories:

1. That the debtor made a “preferential” payment to a creditor, as defined under Section 547(b) of the United States Bankruptcy Code (the “Code”); or
2. That the debtor engaged in a fraudulent transfer, as defined under Section 548(a) of the Code or applicable state law.

My previous alert addressed preferential transfers under Section 547(b) and the defenses available against such claims.

This alert focuses on the second theory of liability frequently asserted against business owners—fraudulent transfers under Section 548 of the Code—and the defenses available to recipients of these demand letters. It is important to note that many states have their own fraudulent transfer statutes, which trustees may also invoke. While the defenses discussed here are specific to the Code, the defenses available under the Code and state law overlap in material respects.

Background on Section 548

Section 548 of the Code allows a trustee to avoid transfers made or obligations incurred by the debtor within two years before the filing of the bankruptcy petition, if the transfers were made with

actual intent to hinder, delay, or defraud creditors, or if the debtor received less than reasonably equivalent value in exchange while being insolvent or becoming insolvent as a result of the transfer.

There are essentially two theories of liability under Section 548: (i) the actual fraudulent transfer; and (ii) the constructive fraudulent transfer.

An actual fraudulent transfer is made with an intent to hinder, delay or defraud creditors. Because intent is difficult to prove, courts have established certain “badges of fraud” that are indicative of a debtor’s intent to defraud creditors. Examples of the “badges of fraud” include, but are not limited to: (i) a transfer to an insider such as an affiliate; (ii) the debtor retained possession or control of the asset notwithstanding the transfer; (iii) the transfer was concealed; (iv) the debtor was threatened with a lawsuit before the transfer was made; and (v) the transfer was of substantially all the debtor’s assets.

A constructive fraudulent transfer is one in which the debtor does not receive “reasonably equivalent value” in exchange for the transferred asset and the debtor: (i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation; (ii) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; (iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor’s ability to pay as such debts matured; and (iv) 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.

Common Defenses to Section 548 Fraudulent Transfer Claims

1. Good Faith and Reasonably Equivalent Value (Sections 548(c) and 550(b)(1))

A primary defense under Section 548 is that the transferee acted in good faith and provided reasonably equivalent value in exchange for the transfer. To successfully invoke this defense, the transferee must demonstrate:

- **Good Faith:** The transferee must prove that they accepted the transfer without knowledge of the debtor’s fraudulent intent or financial instability.
- **Reasonably Equivalent Value:** The transferee must show that the value exchanged was fair and comparable to the value of the property transferred. This requires a factual analysis comparing the value of the assets transferred to the consideration received.

2. The Safe Harbor Defense (Section 546(e))

Excepted from the scope of a fraudulent transfer are settlement payments or transfers in connection with a securities contract to the extent they are made by or to (or for the benefit of) a financial institution, such as a commodity broker, contract merchant, financial institution, financial participant, or securities clearing agent.

3. Attack the Elements of the Fraudulent Transfer Claim

A common defense strategy is to attack the other elements of the fraudulent transfer:

- **Insider:** If an actual fraudulent transfer claim is premised upon a transfer to an “insider,” a company may defend itself against such an allegation by disputing that it meets the definition of an “insider” as set forth in Section 101(31) of the Code.
- **Solvency:** In the context of a constructive fraudulent transfer and an actual fraudulent transfer premised upon insolvency, a company may defend itself by demonstrating that the contested transfer did not leave the debtor insolvent or with unreasonably small capital. With respect to this element, it is important to consider that the party contesting the transfer likely possesses an information advantage on the issue of solvency prior to initiation of discovery.
- **Statute of Limitations:** Pursuant to the Code, the action to avoid the transfer must be commenced by the later of: (i) two years after the bankruptcy was filed; or (ii) one year after the appointment of a trustee in a bankruptcy case. Moreover, the subject transfer must have occurred in the two years immediately preceding the bankruptcy filing. (If the fraudulent transfer claim is brought under state statute, the statute of limitations period may be longer.)

Conclusion

Defending against a fraudulent transfer claim under Section 548 requires a comprehensive understanding of the defenses available and a careful analysis of the facts surrounding the transfer. If you or your company are facing such claims, it is crucial to consult with experienced legal counsel to explore and assert the appropriate defenses.

This legal alert is intended for informational purposes only and does not constitute legal advice. Please consult with an attorney for advice regarding your specific situation.

For further information or to discuss, please contact Franklin Barbosa, Jr., Esq. at fb@spsk.com.

DISCLAIMER: This Alert is designed to keep you aware of recent developments in the law. It is not intended to be legal advice, which can only be given after the attorney understands the facts of a particular matter and the goals of the client.