LITIGATING AVOIDANCE ACTIONS

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CHAPTER ___

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I. INTRODUCTION[1]

Chapter 5 of the Bankruptcy Code grants trustees the power to avoid certain transfers. The most common claims involve Section 547 preferences, Section 548 fraudulent transfers, and Section 549 unauthorized post-petition transfers. While an entire paper could be devoted to the litigation of any one of these claims, this paper will provide a general overview of all these actions and basic tips for effective prosecution and defense of such claims.

II. PREFERENTIAL TRANSFERS

Under 11 U.S.C. §§ 547 and 550, a bankruptcy trustee or a Chapter 11 debtor in possession (**"DIP"**) may recover, for the bankruptcy estate's benefit, property that was transferred or the value of such property. *See* 11 U.S.C. § 1101(1). 11 U.S.C. § 547(b) defines a preference as:

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 bankruptcy petition if the transfer was made to a *non-insider* of the debtor; or

 (B) within one year before the date of the filing of the bankruptcy petition, if such creditor at the time of such transfer was an *insider* of the debtor; and

(5) enables such creditor to receive more than such creditor would receive if –

 (A) the case was a Chapter 7 liquidation;

 (B) the transfer had not been made; and

 (C) such creditor received payment of such debt to the extent provided by the Bankruptcy Code's provisions.

A. "Transfer" Defined

11 U.S.C. § 101(54) defines a "transfer" as: (A) the creation of a lien; (B) the retention of title as a security interest; (C) the foreclosure of a debtor's equity of redemption; or (D) each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing or parting with (i) property; or (ii) an interest in property. However, 11 U.S.C. § 101(54)'s references to "property" and "interests in property" are matters of state law where there is no controlling federal law. *Barnhill v. Johnson*, 503 U.S. 393, 398 (1992)*, quoting Butner v. United States*, 440 U.S. 48, 54 (1979) ("Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law.").

B. To or For Creditor's Benefit

Pursuant to 11 U.S.C. § 101(10)(A), a "creditor" is an "entity that has a claim against the debtor that arose at or before the order for relief concerning the debtor." The Bankruptcy Code broadly defines a "claim" to include all rights to payment or equitable remedies that give rise to a right to payment regardless of whether they are reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured. *See* 11 U.S.C. § 101(5).

C. Antecedent Debt

The Bankruptcy Code defines a "debt" as "liability on a claim." *See* 11 U.S.C. § 101(12). While the Bankruptcy Code does not define an "*antecedent* debt," courts typically hold that an "antecedent debt" is one that was incurred before the transfer was made. *See In re Ramba*, 416 F.3d 394, 399 (5th Cir. 2005); *see also Floyd v. Schindler*, 204 B.R. 510, 516 (Bankr. S.D. Tex. 1995)*; see also Floyd v. Dunson*, 209 B.R. 424, 432 (Bankr. S.D. Tex. 1997).

D. Insolvency

A transfer may not be avoided under 11 U.S.C. § 547 unless the debtor was insolvent at the time of the transfer. 11 U.S.C. § 547(b)(3); *see also In re Ramba.*, 416 F.3d at 403. Pursuant to 11 U.S.C. § 101(32), a debtor is insolvent when the sum of its debts exceeds the sum of its assets at a fair valuation. Courts usually refer to this test as the "balance sheet test." *See In re Lamar Haddox Contractor, Inc.*, 40 F.3d 118, 121 (5th Cir. 1994); *see also Askanase v. Fatjo*, 130 F.3d 657, 671 (5th Cir. 1997). After engaging in this test, courts generally "engage in the 'fair valuation' of the debts and property shown on the [debtor's] balance sheet." *See In re Lamar Haddox Contractor, Inc.*, 40 F.3d at 121.

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Because a debtor's fair value may not be equal to the value shown on the debtor's balance sheet, courts may determine the fair value of the debts by "estimating what the debtor's assets would realize if sold in a prudent manner in current market conditions." *See id., quoting Pembroke Dev. Corp. v. Commonwealth Sav. & Loan Ass'n*, 124 Bankr. 398, 402 (Bankr. S.D. Fl. 1991). Notwithstanding this test, 11 U.S.C. § 547(f) creates a rebuttable presumption that the debtor is insolvent during the 90 days preceding the bankruptcy filing. *See In re Ramba, Inc.*, 416 F.3d at 403.

E. Timing

In order to constitute a preference, a transfer made to a *non-inside*r of the debtor must be made within 90 days of the bankruptcy filing. However, the period is extended to one year for *insiders*. 11 U.S.C. § 547(b)(4)(B). 11 U.S.C. § 101(31)'s definition of "insider" is not exclusive. It includes, among others, an individual debtor's relatives, a general partner of a debtor, a partnership in which a debtor is a general partner, a director, officer, or person in control of a debtor-corporation, and a managing agent of a debtor.

F. Preferential Effect

A transfer is preferential if, as a result of the transfer, the transferee-creditor "received a greater percentage recovery on its debt than it would otherwise have received had it looked solely to distribution from the Chapter 7 estate for its payment." *Krafsur v. Scurlock Permian Corp.*, 171 F.3d 249, 253-54 (5th Cir. 1999).

III. COMMON DEFENSES TO PREFERENTIAL CLAIMS

11 U.S.C. § 547(c) establishes certain statutory defenses to a preferential transfer claim. Thus, even if a trustee can meet its burden of proof under 11 U.S.C. § 547(b), certain claims may still fail if the defendant can establish any of the defenses available under 11 U.S.C. § 547(c). *See* 11 U.S.C. § 547(g).

"New value" is a key element in some of the defenses discussed below. 11 U.S.C. § 547(a)(1) defines "new value" as: (1) money; (2) money's worth in goods, services, or new credit; or (3) release by a transferee of property previously transferred to the transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property. However, "new value" does not include substituting one obligation for an existing obligation. 11 U.S.C. § 547(a)(2).

A. Contemporaneous Exchange for New Value

Under 11 U.S.C. § 547(c)(1), the trustee or DIP may not avoid a transfer to the extent –

(A) the debtor and the creditor intended that the transfer be a contemporaneous exchange for new value given to the debtor; and

(B) the transfer was, in fact, a substantially contemporaneous exchange.

Thus, this defense only protects preferential transfers to the extent that the creditor can prove that the value received by the debtor equals the value the creditor gave. *See* ALAN N. RESNICK & HENRY J. SOMMER, COLLIER ON BANKRUPTCY § 547.04[1] (15th ed. 2007). An example where this defense might arise would be a C.O.D. payment.

B. Ordinary Course of Business

11 U.S.C. § 547(c)(2) provides that a trustee or DIP may not avoid a transfer to the extent that –

(1) such transfer 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

(2) 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 business terms.

This defense protects recurring, customary credit transactions that are made in the ordinary course of the debtor and the transferee's businesses. *See* ALAN N. RESNICK & HENRY J. SOMMER, COLLIER ON BANKRUPTCY § 547.04[2] (15th ed. 2007). It was intended not only to encourage creditors to deal with troubled debtors, but also "to leave undisturbed the normal financial relations" between debtors and their creditors. *Barnhill*, 503 U.S. at 402; *see also* H.R. REP. NO. 95-595, at 373-74 (1997). It was also broadened by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), so that it is no longer necessary to prove both the subjective and objective element of the defense.

C. Purchase Money Security Interests

Under 11 U.S.C. § 547(c)(3), a trustee or DIP may not avoid a transfer that creates a security interest

in property acquired by the debtor –

(A) to the extent the security interest secures new value, and –

(i) the new value is given at or after the signing of the security agreement;

(ii) the security agreement describes such property as collateral;

(ii) the new value is given by or on behalf of the secured party under the security agreement;

(iii) the debtor in fact used the new value to acquire such property; and

(B) the new value is perfected on or before 30 days after the debtor receives possession of such property.

This defense "protects a transfer of a security interest to secure an 'enabling loan.'" ALAN N. RESNICK & HENRY J. SOMMER, COLLIER ON BANKRUPTCY § 547.04[3] (15th ed. 2007). In other words, a trustee or DIP may not avoid a security interest for a loan the debtor used to acquire the encumbered property. *Fidelity Financial Services, Inc. v. Fink*, 522 U.S. 211, 212 (1998).

This defense requires the security interest to be perfected on or before 30 days after the debtor receives possession of the property. 11 U.S.C. § 547(c)(3)(B). The United States Supreme Court has interpreted this to mean that state law perfection requirements[2] must be satisfied within the time limit established by 11 U.S.C. § 547(c)(3)(B) in order for the defense to apply. *Fidelity Financial Services*, 522 at 212.

D. Subsequent New Value

Under 11 U.S.C. § 547(c)(4), a trustee or DIP may not avoid a transfer if –

(1) the creditor gave new value to or for the debtor's benefit;

(2) the creditor gave such new value after the preferential transfer;

(3) such new value is not secured by an unavoidable security interest; and

(4) the debtor has not repaid such new value with an otherwise unavoidable transfer.

See 11 U.S.C. § 547(c)(4); *In re Toyota of Jefferson*, 14 F.3d 1088, 1092, 1093 n.2 (5th Cir. 1994).

Simply put, if after receiving an otherwise preferential transfer from the debtor, the creditor then grants new unsecured credit to the debtor, the trustee or DIP may not be able to avoid the transfer. *See e.g., In re Toyota of Jefferson*, 14 F.3d 1088 (5th Cir. 1994) (holding that new value could offset avoidable preferential transfers provided the new value was repaid with a transfer that would have been avoidable if not for 11 U.S.C. § 547(c)(4)). There are two policy reasons behind this defense. First, creditors who continue to extend credit to troubled debtors are merely increasing any loss to themselves in the event the debtor files for bankruptcy. *Id.* at 1091. Second, this defense encourages "creditors to continue their revolving credit arrangements with financially troubled debtors, potentially helping the debtor avoid bankruptcy altogether." *Id.*

E. Consumer Debts

11 U.S.C. § 547(c)(8) provides that a trustee or DIP may not avoid a transfer of less than $600.00 if the debtor is an individual whose debts are primarily consumer debts. The Bankruptcy Code defines a "consumer debt" as a "debt incurred by an individual primarily for a personal, family, or household purpose." 11 U.S.C. § 101(8).

F. Non-Consumer Debts

Pursuant to 11 U.S.C. § 547(c)(9), a trustee or DIP may not avoid a transfer of less than $5,475.00[3] if the debtor's debts are primarily non-consumer debts. The dollar amount provided in 11 U.S.C. § 547(c)(9) is adjusted every three years to reflect changes in the Consumer Price Index for All Urban Consumers. *See* 11 U.S.C. § 104(b).

G. Earmarking Doctrine

While the earmarking doctrine is not a statutory defense, it is based on 11 U.S.C. § 547(b) which requires a transfer of property belonging to the debtor. Under the earmarking doctrine, if a creditor provides

[2] Keep in mind that "perfection" under 11 U.S.C. § 547(c)(3)(B) turns on 11 U.S.C. § 547(e)(1)'s definition of "perfection." *See Fidelity Financial Services, Inc. v. Fink*, 522 U.S. 211, 214 (1998).

[3] The amount was adjusted from $5,000.00 to $5,475.00 on April 1, 2007.

funds to a debtor to pay a specific indebtedness to another creditor, it may be argued that proceeds never become property of the debtor. *See Coral Petroleum, Inc. v. Banque Paribas London*, 797 F.2d 1351, 1356 (5th Cir. 1986). To qualify for this defense, the transferee must typically prove:

(1) "the existence of an agreement between the new lender and the debtor that the new funds will be used to pay a specified antecedent debt;

(2) performance of that agreement according to its terms; and

(3) the transaction viewed as a whole (including the transfer in of the new funds and the transfer out to the old creditor) does not result in any diminution of the estate."

McCuskey v. Nat'l Bank of Waterloo, 859 F.2d 561, 566 (8th Cir. 1988).

IV. FRAUDULENT TRANSFERS AND STRONG ARM POWERS

11 U.S.C. §§ 548 and 550 provide that the trustee or DIP may recover for the bankruptcy estate's benefit any property transferred or the value of property transferred or obligation incurred, if it falls within the scope of 11 U.S.C. § 548(a). Under § 548(a), a transfer of the debtor's interest in property or an obligation incurred by the debtor is fraudulent if it was made or incurred within two years before the bankruptcy filing, and the debtor voluntarily or involuntarily –

(1) made the transfer or incurred the obligation with <u>actual intent</u> to hinder, delay, or defraud present or future creditors; *or*

(2) received <u>less than a reasonably equivalent value</u> in exchange for such transfer or obligation; and either:

(i) was insolvent on the date the transfer was made or the obligation was incurred, or became insolvent as a result of the 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, debtors that would be beyond the debtor's ability to pay as such debts matured; or

(iv) made such transfer or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

Among other things, the "strong arm" powers of 11 U.S.C. § 544[4] also allow the trustee or DIP to avoid a transfer that falls within the scope of the TEXAS UNIFORM FRAUDULENT TRANSFER ACT (**"UFTA"**), codified in TEX. BUS. & COM. CODE §24.001, *et. seq.*[5] While the UFTA and 11 U.S.C. § 548 are similar, the look-back periods differ. 11 U.S.C. § 548 only allows a fraudulent conveyance action for transfers or obligations that occurred within the two year period preceding the bankruptcy. On the other hand, the UFTA provides for a four year look-back period with respect to certain transfers.[6] The UFTA also allows a cause of action for a fraudulent conveyance based on the debtor's actual intent to hinder, delay, or defraud a future or present creditor even if it did not occur within four years, as long as it is brought within one year after the conveyance was discovered or could reasonably have been discovered. TEX. BUS. & COM. CODE §

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[4]11 U.S.C. § 544 provides the trustee or DIP with the rights that applicable non-bankruptcy law would provide to one of the following parties as of the bankruptcy filing: (1) a judicial lien creditor on a simple contract; (2) a creditor with an unsatisfied writ of execution against the debtor; and (3) a bona fide purchaser of debtor's real property. *See In re Zedda*, 103 F.3d 1195, 1201 (5th Cir. 1997); *see e.g., In re Robertson*, 203 F.3d 855, 865 (5th Cir 2000) ("The extent of the trustee's rights as a bona fide purchaser of real property...is measured by the substantive law of the state governing the property in question.").

[5]*See In re Zedda*, 103 F.3d 1195, 1201 (5th Cir. 1997) ("In essence, [11 U.S.C.] § 544 allows the trustee to step into the shoes of a creditor for the purpose of asserting causes of action under state fraudulent conveyance laws and confers on the trustee the status of a hypothetical creditor or bona fide purchaser as of the commencement of the case.").

[6]However, trustees or DIPs may only reach back one year to avoid a conveyance if the claim arose before the transfer was made, the transfer was made to an insider for an antecedent debt, the debtor was insolvent at the time of the transfer, and the insider had reasonable cause to believe that the debtor was insolvent as set forth in TEX. BUS. & COM. CODE § 24.006(b). *See* TEX. BUS. & COM. CODE § 24.010.

24.010(a)(1). Equally important, the UFTA allows a successful trustee to recover her reasonable and necessary attorney's fees. *See* TEX. BUS. & COM. CODE § 24.013.

Under the UFTA, future and present creditors of the debtor may bring a fraudulent conveyance cause of action if the debtor made a transfer or incurred an obligation:

(1) with actual intent to hinder, delay, or defraud any creditor of the debtor; or

(2) without receiving a reasonably equivalent value in exchange for the transfer or obligation, *and* the debtor:

(A) was engaged or was about to engage in a business or transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

(B) intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due.

TEX. BUS. & COM. CODE § 24.005(a).

The UFTA also allows present creditors[7] to bring a fraudulent conveyance action if:

(1) (i) the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation; and (ii) the debtor was insolvent[8] at that time or became insolvent as a result of the transfer or obligation; and

(2) (i) the transfer was made to an insider[9] for an antecedent debt; (ii) the debtor was insolvent at that time; and (iii) the insider had reasonable cause to believe that the debtor was insolvent.

TEX. BUS. & COM. CODE § 24.006.

Since the element of "actual intent" can be difficult to prove, the UFTA provides a non-exclusive list of conduct ("badges of fraud") from which intent may be inferred, including whether:

(1) the transfer or obligation was to an insider;

(2) the debtor retained possession or control of the property transferred after the transfer;

(3) the transfer or obligation was concealed;

(4) before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;

(5) the transfer was of substantially all the debtor's assets;

(6) the debtor absconded;

(7) the debtor removed or concealed assets;

(8) the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

(9) the debtor was insolvent or became insolvent shortly after a substantial debt was incurred;

(10) the transfer occurred shortly before or shortly after a substantial debt was incurred; and

[7] To bring a cause of action based on TEX. BUS. & COM. CODE § 24.006, the creditor's claim must have arisen before the transfer was made or the obligation was incurred.

[8] Like the Bankruptcy Code, the UFTA provides that a debtor is insolvent where the sum of its debts exceeds the sum of its assets at a fair valuation. *See* TEX. BUS. & COM. CODE § 24.003(a). But, the UFTA also states "a debtor who is generally not paying the debtor's debts as they become due is presumed to be insolvent." *See* TEX. BUS. & COM. CODE § 24.003(b).

[9] TEX. BUS. & COM. CODE § 24.002(7) contains a non-exclusive list of "insiders." *See Matter of Holloway*, 955 F.2d 1008, 1011 (5th Cir. 1992) (providing that in determining whether one is an "insider," cases usually focus on (1) how close the transferee's and debtor's relationship is; and (2) whether the transaction was conducted as arm's length).

(11) the debtor transferred the essential assets of the business to the lienor who transferred the assets to an insider of the debtor.

TEX. BUS. & COM. CODE § 24.005(b).

11 U.S.C. § 548 and the UFTA both contain "constructive fraud" provisions, which essentially provide that a fraudulent conveyance action may be brought when the debtor did not receive "reasonably equivalent value" in exchange for a transfer or obligation. Thus, there is no need to prove fraudulent intent under these provisions. So the question becomes, what is "reasonably equivalent value?" Under both statutes, "value" is given when property is transferred or an *antecedent* debt is secured or satisfied. *See* TEX. BUS. & COM. CODE § 24.004(a); *see also* 11 U.S.C. § 548(d)(2)(A). But, 11 U.S.C. § 548 further states that value is given when a *present* debt is secured or satisfied. Only the UFTA defines the term "reasonably equivalent value."

Under § 24.004(b), "a person gives reasonably equivalent value if the person acquires an interest of the debtor in an asset pursuant to a regularly conducted, non-collusive foreclosure sale or execution of a power of sale for the acquisition or disposition of the interest of the debtor upon default under a mortgage, deed of trust or security agreement." Furthermore, "'reasonably equivalent value' includes without limitation, a transfer or obligation that is within the range of values for which the transferor would have sold the assets in an arm's length transaction. TEX. BUS. & COM. CODE § 24.004(d).

V. UNAUTHORIZED POST-PETITION TRANSFERS

Pursuant to 11 U.S.C. § 549(a), the trustee of DIP may avoid a transfer of property of the estate –

(1) that occurs after the commencement of the case; and

(2) (A) that is authorized only under 11 U.S.C. § 303(f) or 11 U.S.C. § 542(c); or (B) that is not authorized under title 11 or by the court.

Sections 549(b) and (c) contain the only two statutory defenses to an unauthorized post-petition transfer claim. Section 549(b) deals with post-petition transfers in an involuntary case, and Section 549(c) essentially states that trustees may not avoid unauthorized post-petition transfers of real property to good faith purchasers for "present fair equivalent value." Defendants may try to argue that the property at issue was not property of the estate and/or invoke the earmarking doctrine to get around a Section 549 claim.

It should also be noted that FED. R. BANKR. P. 6001 provides that "any entity asserting the validity of a transfer under § 549 of the Code shall have the burden of proof."

VI. AVOIDANCE ACTION LIMITATIONS

Pursuant to 11 U.S.C. § 546(a), the trustee or DIP may not commence an action to avoid a preferential transfer or a fraudulent transfer after the earlier of –

(1) the later of –

(A) 2 years after the order of relief is entered; or

(B) 1 year after the appointment or election of a trustee, if the appointment or election occurs before the 2 year period specified in (A); or

(2) the time the case is closed or dismissed.

Under 11 U.S.C. § 549(d), the trustee or DIP may not commence an action to avoid a post-petition transaction after the earlier of –

(1) 2 years after the date of the transfer sought to be avoided; or

(2) the time the case is closed or dismissed.

VII. LITIGATION PRACTICE TIPS

A. Obtain All Relevant Client Files and Documents

As the representative of the bankruptcy estate,[10] trustees have a duty to investigate the debtor's financial

[10] *See* 11 U.S.C. § 323(a) ("The trustee in a case under this title is the representative of the estate."); *see also* 11 U.S.C. § 1101(7) (vesting a Chapter 11 DIP with almost all the same rights, powers, functions, and duties of a trustee).

affairs and determine whether actionable avoidance actions exist for the benefit of the estate.[11] Some of the most helpful records to obtain when making these determinations include:

(1) invoices, Quick Book files, aging reports, check ledgers, and inter-company transfer records;

(2) bank statements, cancelled checks, and wire transfer receipts;

(3) tax returns and related documents, such as W-2s and 1099s; and

(4) contracts and communications, including e-mails and electronic files.

B. § 341 Meetings

Debtors will also be examined under oath at a meeting of the creditors. FED. R. BANKR. P. 2003(b)(1); 11 U.S.C. § 343. "The purpose of examination is to inquire into financial matters, matters affecting the [bankruptcy] estate and discharge." ALAN N. RESNICK & HENRY J. SOMMER, COLLIER ON BANKRUPTCY § 1.03[2][d][i] (15th ed. 2007). This provides an excellent opportunity to determine whether such records exist and where they are located.

C. Filing Suit and Preparing for Trial

1. Venue

Venue rules were recently changed with the passage of BAPCPA. Under 28 U.S.C. § 1409(a), proceedings arising under title 11 or arising in or related to a title 11 case typically may be commenced in the district in which the case is pending. However, 28 U.S.C. § 1409(b) now states:

> Except as provided in subsection (d) of this section, a trustee in a case under title 11 may commence a proceeding arising in or related to such case to recover a money judgment of or property worth less than $1,100 or a consumer debt of less than $16,425 or a debt (excluding a consumer debt) against a non-insider of less than $10,950, only in the district court for the district in which the defendant resides.

2. Alternative Claims

When preparing the complaint, identify and assert any other potential claims that fit your particular fact pattern. For example, if you are asserting claims under Section 548, you will also want to include a claim under the UFTA which will allow you to recover reasonable attorney's fees if successful. If you are asserting claims against insiders and it is unclear whether there is a legitimate antecedent debt, assert alternative claims under Section 548 and the UFTA. If you are asserting avoidance claims against officers or directors, explore potential claims for breach of fiduciary duty, which will shift the burden of proof to the defendants and allow for the potential recovery of attorney's fees, punitive damages, and disgorgement.

3. Spoliation

Early in the case, you should also determine whether there has been any spoliation of evidence. *Smith v. American Founders Financial Corp.*, 365 B.R. 647, 681 (Bankr. S.D. Tex. 2007)*, quoting Andrade Garcia v. Columbia Med. Ctr.*, 996 F. Supp. 605, 615 (E.D. Tex. 1998) (defining "spoliation" as "'the destruction of evidence, or the significant and meaningful alteration of a document or instrument.'"). Once a party knows or should know that evidence may be relevant to present or future litigation, an obligation to preserve the evidence arises. *Smith*, 365 B.R. at 681. Upon a showing of "bad faith" or "bad conduct," the United States Court of Appeals for the Fifth Circuit allows an adverse inference against the destroyer of the evidence. *Condrey v. Suntrust Bank of Georgia*, 431 F.3d 191, 203 (5th Cir. 2005).

4. Discovery

During discovery, devote the time necessary to prepare specific interrogatories to prove up the elements of your claims or defenses. If you are asserting fraudulent transfer claims against corporate insiders and expect them to allege that money was transferred for services provided, include specific requests for production that seek personal tax returns, W-2s or K-1s.

[11] *See* 11 U.S.C. § 704(a)(1) and (4); 11 U.S.C. § 1106(a)(4); and 11 U.S.C. § 1302(b)(1).

Determine if the payments were treated as income (with taxes withheld and paid) or as loans. If the debtor was a pass-through entity (such as an LLC), look at the insider's K-1 and the debtor's Form 1065 to determine if there is a negative recourse capital account, which may give rise to a claim under Section 542. Also, determine whether you will need expert testimony to prove up any elements, such as valuation of assets, insolvency, ordinary course, and preferential effect of the transfer (chapter 7 liquidation). Be sure to designate experts in accordance with local rules and scheduling orders. Use requests for admission to try and authenticate any documents that you may want to use at trial.

5. Know the Local Rules

Perhaps most importantly, make sure you KNOW the local rules. Local rules vary widely from district to district and court to court. Likewise, many districts will have appendices to their local rules and standing orders, all of which can materially affect the presentation of your case and the pre-trial deadlines.

VIII. JUDGMENT AND COLLECTION

Pursuant to FED. R. BANKR. P. 7069 and FED. R. CIV. P. 69(a)(1),[12] after the rendition of a money judgment in an adversary proceeding "the procedure on execution – and in proceedings supplementary to and in aid of judgment or execution – must accord with the procedure of the state where the court is located, but a federal statute governs to the extent it applies."

Also note that "in using state practices and procedures to enforce a federal money judgment, there should be substantial conformity with state law requirements." ALAN N. RESNICK & HENRY J. SOMMER, COLLIER ON BANKRUPTCY § 7069.02 (15th ed. 2007).

A. Record an Abstract of Judgment

All judgment creditors should record an abstract of judgment (**"abstract"**) as soon as possible after entry of judgment. An abstract is a summary of a judgment, containing the elements set forth in TEX. PROP. CODE § 52.003. Most importantly, it creates a lien on the non-exempt real property of the judgment debtor when recorded and indexed in the appropriate public office. *See* TEX. PROP. CODE § 52.001. Once a judgment creditor records an abstract, a judgment lien attaches to and is perfected against the judgment debtor's non-exempt real property in the county where it is recorded. *See* TEX. PROP. CODE § 52.001 *et seq.*; *see also Wilson v. Dvorak*, 228 S.W.3d 233-234 (Tex. App.-San Antonio 2007, pet. filed); *see also Allied First Nat'l Bank of Mesquite v. Jones*, 766 S.W.2d 800, 802 (5th Cir. 1988), *citing Citicorp Real Estate v. Banque Arabe*, 747 S.W.2d 926, 929 (Tex. App.-Dallas 1988, writ ref'd n.r.e.).

By perfecting the judgment lien, the judgment creditor validates his security interest in the judgment debtor's real property against both subsequent secured creditors and subsequent purchasers of the judgment debtor. *See Hoffman, McBryde & Co., P.C. v. Heyland*, 74 S.W.3d 906, 909 (Tex. App.–Dallas 2002, no pet.), *citing John F. Grant Lumber Co. v. Hunnicutt*, 143 S.W.2d 976 (Tex. Civ. App.–Waco 1940, no writ); *see e.g., Citizens Bank v. Del-Tex Inv. Co.*, 123 S.W.2d 450 (Civ. App.–San Antonio 1939, writ dism'd judgm't cor.). Because a judgment lien only attaches to and perfects a security interest in the judgment debtor's real property located in the county where the abstract is recorded, the judgment creditor should record an abstract in every county where the judgment debtor might possibly own an interest in real property.

A judgment creditor can apply for an abstract with the judge or the clerk of the court in which judgment was rendered. TEX. PROP. CODE § 52.002(a). The judge or clerk must then prepare, certify, and deliver an abstract to the applicant. *Id.*

Pursuant to TEX. PROP. CODE § 52.003(a), a document constitutes an abstract if it contains all of the following information:

1) The plaintiff's and defendant's names;

2) The defendant's birthdate, if available;

3) The last three numbers of the defendant's

[12] FED. R. BANKR. P. 7069, titled "Execution," provides that FED. R. CIV. P. 69 applies in adversary proceedings.

driver's license and social security number, if available;

4) The number of the suit in which judgment was rendered;

5) The defendant's address, or if the address is not shown in the suit, the nature of the citation and the date and place the citation was served;

6) The date on which judgment was rendered;

7) The amount for which the judgment was rendered and the balance due;

8) The amount of the balance due, if any, for child support arrearage; and

9) The rate of interest specified by the judgment.

Furthermore, the abstract *may* show the judgment creditor's mailing address. TEX. PROP. CODE § 52.003(b). This is advisable because if a judgment abstracted after September 1, 1993, does not contain the judgment creditor's mailing address, the abstract may not be recorded unless the judgment creditor pays a penalty filing fee. TEX. PROP. CODE § 52.0041(a).

Immediately after receiving the abstract, the county clerk must record it in the county property records and note the date and hour it was received. TEX. PROP. CODE § 52.004(a). The clerk enters the abstract on the real property records alphabetical index, showing the name of each plaintiff and defendant in the judgment and the volume and page or instrument number in the records where the abstract is recorded. TEX. PROP. CODE § 52.004(b).

The onus is on the judgment creditor to ensure that the abstract is properly recorded by the clerk. *Wilson v. Dvorak*, 228 S.W.3d 233 (Tex. App.-San Antonio 2007, pet. filed). Therefore, following the filing of an abstract, a judgment creditor should verify that the clerk has indexed the abstract properly.

B. Domesticate the Judgment

TEX. PROP. CODE § 52.007 allows a judgment rendered in a federal court located in Texas to be recorded and indexed in accordance with Chapter 52 of the TEXAS PROPERTY CODE, on the certificate of the clerk of the court (which may act as the abstract). However, a judgment creditor whose judgment was rendered by a federal court located in a state other than Texas, must first "domesticate" its judgment.[13] Anytime after a final judgment[14] for recovery of money or property has been entered in any court of appeals, district court, or bankruptcy court, the judgment creditor should take steps to domesticate the judgment so that the judgment has the same effect and may be enforced as if it had been rendered in that district. *See* 28 U.S.C. § 1963. Thus, even if a judgment creditor obtains a judgment from a bankruptcy court in Texas, he should domesticate the judgment if he wishes to use state law enforcement officers to execute on any writs. Under 28 U.S.C. § 1963, the judgment creditor domesticates (or "registers") the judgment by filing a certified copy of the judgment in any other judicial district.

C. Post-Judgment Discovery

Pursuant to FED. R. BANKR. P. 7069 and FED. R. CIV. P. 69(a)(2), after the rendition of judgment in an adversary proceeding, the judgment creditor may seek discovery to aid in the enforcement of its judgment. "The judgment creditor may obtain discovery from any person – including the judgment debtor – as provided in [the FEDERAL RULES OF CIVIL PROCEDURE] *or* by the procedure of the state where the court is located." FED. R. CIV. P. 69(a)(2) (emphasis added); *see* TEX. R. CIV. P. 190-215. Accordingly, judgment creditors have the option of using whichever discovery rules (federal or state) are broader in order to aid in the enforcement of

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[13] *See* TEX. PROP. CODE § 12.013 ("A judgment of a court may be recorded if the judgment is of a court expressly created or established under the constitution or laws...of the United States; and the judgment is attested under the signature and seal of the clerk of the court that rendered the judgment.").

[14] *See* 28 U.S.C. § 1963 (providing that a judgment becomes "final" for purposes of this section: (1) by appeal; or (2) by expiration of the time for appeal; or (3) when ordered by the court that entered the judgment for good cause shown).

their judgment. *See Natural Gas Pipeline Co. v. Energy Gathering, Inc.*, 2 F.3d 1397, 1405 (5th Cir. 1993); *see also* ALAN N. RESNICK & HENRY J. SOMMER, COLLIER ON BANKRUPTCY § 7069.02 (15th ed. 2007)(stating that judgment creditors may choose whether to use federal deposition rules or state rules in examination of the debtor or third persons in order to discover assets or other information in aid of enforcing their judgment).

Pre-trial and post-judgment discovery are governed by the same procedural rules, but the effective scope of permissible discovery differs substantially. *See Natural Gas Pipeline*, 2 F.3d at 1405. In both pre-trial and post-judgment discovery, "parties may obtain discovery regarding any non-privileged matter that is relevant to any party's claim or defense." FED. R. CIV. P. 26(b)(1); *compare* TEX. R. CIV. P. 192.3(a). A matter is "relevant" if it is reasonably calculated to lead to the discovery of admissible evidence. *Wiwa v. Royal Dutch Petroleum Co.*, 392 F.3d 812, 820 (5th Cir. 2004)*, citing Wehling v. Columbia Broad. Sys.*, 608 F.2d 1084, 1086 (5th Cir. 1979); *compare Collier Services Corp. v. Salinas*, 812 S.W.2d 372, 376 (Tex. App.-Corpus Christi 1991, orig. proceeding) (providing that under Texas law, a matter is "relevant" if it is reasonably calculated to lead to the discovery of *material* evidence). Usually, a party's assets are irrelevant to a pending action; and thus, they may not be inquired into during pre-trial discovery. On the other hand, in post-judgment discovery, the scope of discovery extends to any matter relevant to collecting the judgment or any matter reasonably calculated to lead to the discovery of information relevant to enforcing the judgment. *See Collier Services Corp.*, 812 S.W.2d at 376. Therefore, in post-judgment discovery, inquiry may be made into the judgment debtor's assets and financial affairs. *See id.*; ALAN N. RESNICK & HENRY J. SOMMER, COLLIER ON BANKRUPTCY § CS2.01[6] (15th ed. 2007).

D. Contempt

Contempt is the penalty for failure to obey court orders. *See In re Davis*, 119 F. 950, 956 (W.D. Tex. 1903); *see also In re Hailey*, 621 F.2d 169, 172 (5th Cir. 1980) ("In contempt proceedings the basic proposition is that all orders and judgments of courts must be complied with."). Pursuant to 11 U.S.C. § 105, "a bankruptcy court can issue any order, including a civil contempt order, necessary or appropriate to carry out the provisions of the bankruptcy code." *In re Galindo*, 2006 U.S. Dist. LEXIS 53077, *4 (S.D. Tex. 2006)*, quoting Placid Refining Co. v. Terrebonne Fuel & Lube, Inc.*, 108 F.3d 609, 613 (5th Cir. 1997); *see also* 11 U.S.C. § 105(a); *see also* COLLIER ON BANKRUPTCY § 105.04. While some courts have held that bankruptcy courts have the inherent power to find civil and criminal contempt, the Fifth Circuit has held that bankruptcy courts may not issue criminal contempt orders. *In re Galindo*, 2006 U.S. Dist. LEXIS at *5; *compare In re Courtesy Inns*, 40 F.3d 1084, 1089 (10th Cir. 1994) and *Chambers v. NASCO, Inc.*, 501 U.S. 32, 44 (1991). Nevertheless, bankruptcy courts can and will issue civil contempt orders if judgment debtors refuse to comply with an order to respond to post-judgment discovery.

A contempt order is characterized as "civil" if it serves: "(1) to enforce compliance with a court's order through coercion; or (2) to compensate a party who has suffered unnecessary injuries or costs because of contemptuous conduct." *In re Galindo*, 2006 U.S. Dist. LEXIS at *5 (S.D. Tex. 2006). On the other hand, a contempt order is characterized as "criminal" if it is intended to punish the contemnor and to vindicate the court's authority. *Gompers v. Bucks Stove & Range Co.*, 221 U.S. 418, 441 (1911); *In re Galindo*, 2006 U.S. Dist. LEXIS at *5.

Judgment debtors may only be held in civil contempt where: (1) they have actual knowledge of the court order; and (2) the order is sufficiently specific to be enforceable. *See In re Hailey*, 621 F.2d 169, 172 (5th Cir. 1980).

If a judgment debtor fails to obey a court order, the judgment creditor should move the bankruptcy court to issue a show cause order to the judgment debtor requiring it to appear and answer before the court to show cause why it should not be held in civil contempt. In connection with the show cause hearing, the judgment creditor may move the court to issue a bench warrant or a writ of attachment authorizing the United States Marshals Service to arrest the judgment debtor upon sight anywhere he may be found and bring him

before the court for a hearing on the show cause order.[15] *See Smith v. Smith*, 145 F.3d 335, 343 (5th Cir. 1998); *see also In re Baum*, 541 F.2d 1166, 1166 (5th Cir. 1976).

[15]*See* Appendix A, Sample Writ of Attachment for the Body of Jane Smith.