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Heightened Pleading Standards Apply to Avoidance Complaints

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Parties to preference and fraudulent transfer actions should pay careful attention to the decision in *Angell, Trustee v. Ber Care, Inc. f/k/a PPS, Inc., et al. (In re Caremerica, Inc.)*, 409 B.R. 737 (Bankr. E.D.N.C. 2009). There, relying upon the new standard for assessing the sufficiency of a complaint set forth by the Supreme Court in *Bell Atl. Corp. v. Twombly*, 550 U.S. 544 (2007) and *Ashcroft v. Iqbal*, 129 S.Ct. 1937 (2009), Bankruptcy Judge J. Rich Leonard dismissed certain avoidance claims and upheld others asserted by a Chapter 7 trustee. *Caremerica* provides useful guidance on whether particular elements of a preference or fraudulent transfer claim have been adequately pled.

***Twombly, Iqbal* and the Rule 8(a)(2) Pleading Standards**

Before *Twombly*, it was well-established that "a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957). But *Twombly* articulated a new pleading standard under FED.R.CIV.P. 8. It replaced *Conley's* liberal "no set of facts" pleading standard with a "facial plausibility" standard. *Twombly*, 550 U.S. at 561-63. *Iqbal* made clear that this new standard applies to all civil actions. *Iqbal*, 129 S.Ct. at 1953.

Under the new standard, a pleading that only offers "labels and conclusions" or "a formulaic recitation of the elements of a cause of action" will not suffice. *Twombly*, 550 U.S. at 555. To survive a motion to dismiss, a complaint must contain sufficient factual matter to "state a claim to relief that is plausible on its face." *Id.* at 556. *Iqbal* reaffirmed the plausibility standard and explained that a claim has

"facial plausibility" when the factual content in the complaint allows the court to draw the "reasonable inference" that the defendant is liable. *Iqbal*, 129 S.Ct. at 1949. The first step in the *Twombly/Iqbal* analysis is to separate the factual allegations, which are entitled to an assumption of truth, from allegations that are disguised as legal conclusions. "Threadbare recitals of the elements of a cause of action, supported by mere conclusory statements, do not suffice." *Id.* Secondly, when the complaint is stripped of these legal conclusions, there must remain factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged. *Id.* Where the remaining facts are merely consistent with a claim, but do not permit the reasonable inference that the defendant is liable, the complaint should be dismissed. *Id.* at 1950.

Fed.R.Bankr.P. 7008(a) makes FED. R.CIV.P. 8 applicable in adversary proceedings. Accordingly, it is not surprising that a court would subject a complaint in an avoidance action to a *Twombly/Iqbal* analysis.

The *Caremerica* Complaint

In *Caremerica*, the trustee filed an adversary proceeding to avoid and recover certain alleged preferential and fraudulent transfers made by the debtors to defendant BER Care, Inc. f/k/a PPS, Inc. ("Ber Care /PPS"). 409 B.R. at 744. The trustee filed an amended complaint (the "Amended Complaint"), alleging that the debtors, for the purpose of protecting their own bank accounts from attachment or garnishment by creditors, transferred funds by and through bank accounts of Ber Care/PPS as a conduit through which funds were distributed to the defendants. *Id.* at 750. The trustee moved to further amend, and several of the defendants filed motions to dismiss for failure to state a claim. *Id.* at 744.

The Amended Complaint included an Exhibit listing each alleged transfer and including specific amounts, dates, check numbers, payee reference numbers, names of payees, account numbers and account names corresponding to each transfer. *Id.* The Exhibit contained a table that identified the dates and amounts of the transfers received by each defendant (the "Table of Transfers"). *Id.* at 750. The Exhibit also included relevant bank statements from the account of PPS, Inc. *Id.* at 744.

Judge Leonard analyzed whether the trustee had adequately pled each element of the preference and fraudulent conveyance claims in light of the heightened *Twombly/Iqbal* pleading standard.

The Preference Claim

Transfer of an Interest of the Debtor in Property

The court found insufficient facts to support the trustee's contention that the funds flowing through the BER Care/PPS bank accounts had originated with the debtors. *Id.* at 750-51. The assertion in the Amended Complaint that "the debtors transferred its (sic) funds into bank accounts operated by the debtors' principals" was merely a conclusory statement that lacked factual support. *Id.* at 750. Similarly, the trustee provided insufficient factual basis for his assertion that "one or more of the debtors, or, in the alternative, the consolidated debtor ... made certain transfers to such defendant in at least the amount listed beside such defendant's name" *Id.* Although the bank statements and Table of Transfers in the complaint's Exhibit lent sufficient factual support to the allegation that various transfers were made from BER Care/PPS accounts to the defendants, they did not indicate the source of the funds entering the BER Care/PPS accounts or which entity initiated each transfer. *Id.* at 750-51.

The allegation that the debtors were "subject to the dominion and control" of owners of BER Care, Inc., failed to give rise to a reasonable inference that the debtors transferred funds to the BER Care/PPS bank accounts. Without more factual support, there was nothing in the Amended Complaint or the Exhibit to rebut the alternative and reasonable possibility that the funds flowing through BER Care, Inc. originated from sources other than the debtors. *Id.* at 751. Accordingly, the trustee's allegations of transfers of interests of the debtors in property failed to meet the "plausibility" standard.

To or for the Benefit of a Creditor

According to the court, the information provided in the Table of Transfers, including the names of transferees and the dates and amounts of each transfer, together with the allegation that "each preferential transfer was made to or for the benefit of the defendant as a creditor of the transferor," plausibly asserted that funds were transferred to the movants. *Id.*

For or on Account of an Antecedent Debt

To satisfy the pleading requirements for this element under *Iqbal*, a plaintiff must allege facts regarding the nature and amount of the antecedent debt. *Id.* The conclusory assertion in the Amended Complaint that each preferential transfer was made "for, or on account

of, an antecedent debt owed by the Transferor to the Defendant before the transfer was made" does not satisfy this burden. *Id.*

Made While the Debtor Was Insolvent

For transfers to insiders made between 90 days and one year of the entry of the order of relief, there is no presumption of insolvency, so the trustee must allege sufficient facts to show that insolvency is plausible. *Id.* at 752. The Caremerica trustee's conclusory statement that "[e]ach preferential transfer was made while the [t]ransferor was insolvent" failed to satisfy this burden. *Id. Compare In re Troll Communications*, 385 B.R. 110, 114 (Bankr.D.Del.2008) (this element satisfied where the complaint contained a valuation of the debtors' accounts payable and other liabilities, a negative valuation of the debtors' tangible net worth, and the trustee provided notes from the debtors' accountant expressing substantial doubt that the debtors could continue as a going concern).

Made Within 90 Days, or Within One Year if the Creditor Was an Insider

The complaint showed it plausible that the alleged transfers occurred within the preference period because the Exhibit specified the dates and amounts of each contested transfer. *Caremerica*, 409 B.R. at 752. But the mere labeling of transferees as "insiders as that term is defined in § 101(31) and used in § 547(b)" without providing supporting facts was conclusory and insufficient to establish a reasonable inference of insider status. *Id.* at 753. Rather, the complaint "must include the basis for asserting that a defendant qualifies as an insider under § 101(31) and facts showing that the alleged relationship is plausible." *Id.* The trustee's complaint provided scant details regarding the relationship between the debtors and the defendants and failed to address in what capacity the defendants were insiders of the debtors. *Id. Compare In re Oakwood Homes*, 340 B.R. 510 (Bankr.D.Del.2006)(allegations of a long-standing, multifaceted relationship in which the defendants dominated and controlled the debtors provided an adequate factual basis to support the assertion that the defendants were insiders).

Enabled Creditor to Receive More Than It Would Under Chapter 7

If the preference defendant is an unsecured nonpriority creditor, this element is satisfied where the trustee alleges facts showing that, in a liquidation, it is plausible that the distribution to general unsecured

creditors would be below 100%. This is because any payment to such a creditor during the preference period would enable the creditor to receive more than it would in a liquidation had the payment not been made. *Caremerica*, 409 B.R. at 753. The *Caremerica* debtors' summary of schedules, reflecting liabilities far greater than assets, was sufficient to satisfy this requirement. *Id.* at 754.

The Fraudulent Transfer Claim

The trustee's constructive fraud claim was not sufficiently pled under *Twombly/Iqbal*. The allegations that the debtors received less than reasonably equivalent value in exchange for the transfers, and that the debtors were insolvent on the date of each transfer or became insolvent as a result of the transfers, simply repeated the elements of a constructive fraud claim. *Id.* at 756. "Missing from the Amended Complaint is an identification of the consideration received by each transferor, information as to why the value of such consideration was less than the amount transferred, and facts supporting the debtors' insolvency at the time of the transfer. In the absence of such factual assertions, the trustee's claims based on constructive fraud fail to meet the Rule 8 pleading standard." *Id.*

The Trustee's Argument for a Relaxed Standard Was Rejected

Opposing the motions to dismiss, the trustee argued that adoption of heightened pleading requirements would impose an undue burden on trustees in avoidance actions. There is precedent for the application of relaxed pleading standards to trustees in preference and fraudulent transfer actions, based on the argument that trustees often inherit incomplete or inaccurate books and records and may not have full cooperation from the debtor, and therefore lack full access to information. See *In re Randall's Island Family Golf Centers, Inc.*, 290 B.R. 55, 65 (Bankr. S.D.N.Y. 2003); *In re Chari*, 276 B.R. 206, 214 (Bankr. S.D. Ohio 2002).

But the Bankruptcy Court rejected this argument. The court observed that a bankruptcy trustee is more likely to have access to the information he needed than the plaintiffs seeking to prove an antitrust conspiracy in *Twombly* or the Pakistani detainee in *Iqbal* who alleged that federal officials purposefully discriminated against him. *Caremerica*, 409 B.R. at 754. "After all, the trustee has theoretically had all of the books and records of the debtors for up to two years prior to bringing these causes of action, with the full discovery powers of the court through 2004 exams and other means available during that time." *Id.*

The Anticipated Impact Of *Caremerica*

Caremerica's primary holding applying a heightened pleading standard to a preference claim based on *Twombly* and *Iqbal* has already been followed. See *In re McLaughlin*, 2009 WL 2878522 (Bankr. D.N.H. Sept. 3, 2009). It is fair to assume that other courts will also follow *Caremerica's* lead.

Caremerica suggests that plaintiffs in avoidance actions will need to work harder. Merely filing, on the eve of the deadline set forth in Code Section 546(a), complaints that simply recite the statutory elements of the claim in formulaic fashion will not suffice. Trustees and other plaintiffs will need to commence their investigations and analyses relatively earlier than in the past so that they can develop facts to formulate complaints that meet the new, more stringent pleading requirements. Such plaintiffs may make increased use of 2004 exams and other discovery tools to obtain sufficient factual support for their complaints. Defendants will be more likely to consider responding to avoidance complaints with motions to dismiss, rather than simply filing answers. Weaker claims for relatively small amounts may not be pursued if the necessary supporting facts are not readily available. The weeding out of marginal claims at the pleading stage is therefore more likely. Additionally, Defendants who have already answered avoidance complaints should consider filing motions for judgment on the pleadings if the complaints they are facing appear not to pass muster under *Twombly/Iqbal* and *Caremerica*.

Notably, Sen. Arlen Specter (D-PA) introduced the Notice Pleading Restoration Act of 2009 (S.1504), to restore the *Conley v. Gibson* standard. Members of the plaintiffs' bar have also begun organizing in opposition to the *Twombly* and *Iqbal* holdings. But unless *Conley* is called out of retirement, the lessons of *Caremerica* cannot be ignored.

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