In the Wake of *Iqbal*, a Shift in Federal Pleading Standards

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Perhaps nothing has altered the federal litigation landscape recently more than the U.S. Supreme Court's decisions in *Bell Atlantic Corp. v. Twombly*. The 3rd U.S. Circuit Court of Appeals noted in its 2009 opinion in *Fowler v. UPMC Shadyside* that "standards of pleading have been in the forefront of jurisprudence in recent years." By July 2009, it had been reported that *Ashcroft v. Iqbal* had already been cited more than 500 times by lower federal courts. Around the same time, it was noted, in Erwin Chemerinsky's August 2009 *California Bar Journal* article, "The Supreme Court Moves to the Right, Perhaps Sharply to the Right," that despite being little more than two years old, *Twombly* was "one of the five most frequently cited Supreme Court cases by lower federal courts in all of American history."

In *Twombly*, the Supreme Court articulated its replacement of the traditional pleading standard under Fed. R. Civ. P. 8 and its 1957 case *Conley v. Gibson*, with a new requirement that a complaint state "enough factual matter" to make the claim "plausible." In 2009, the Supreme Court reaffirmed this paradigm shift in *Iqbal*, adding that a new federal heightened pleading standard requires that "a complaint must contain sufficient factual matter, accepted as true, to state a claim for relief that is plausible on its face" in order to survive a motion to dismiss for failure to state a claim. The traditional notion that a court must accept a complaint's allegations as true was held to apply strictly to factual statements, and not to "threadbare recitals" of a cause of action's elements, supported by mere conclusory statements.

**The Caremerica Decisions**

A series of decisions from the U.S. Bankruptcy Court for the Eastern District of North Carolina in the 2009 Caremerica bankruptcy put avoidance actions to the *Twombly/Iqbal* test. In those cases — *Angell v. BER Care Inc.* (Caremerica I); *Angell v. Haveri* (Caremerica II); and *Angell v. Burrell* (Caremerica III) — the trustee filed a number of adversary complaints alleging certain preferential and fraudulent transfers made by the debtor to the various defendants.
According to the opinion in Caremerica I, the trustee sought to set aside allegedly preferential and fraudulent transfers made by the debtor. When the defendants moved to dismiss the trustee’s complaint under Fed. R. Civ. P. 12(b)(6) for failure to state a claim, the court analyzed the trustee’s allegations in light of the Twombly and Iqbal decisions. The court first found that the trustee’s complaint was insufficient as to the preference claims, holding that the trustee had failed to plead with requisite specificity the majority of the elements of an avoidable preference under Section 547 of the Bankruptcy Code.

Immediately fatal to the trustee’s preference claims was the court’s finding that the trustee had failed to carry his burden in showing that the transfers at issue were transfers of the debtor’s property, the opinion said. Although certain exhibits to his complaint lent sufficient factual support to the trustee’s allegations, the evidence did not indicate the source of the funds entering the bank accounts at issue, or which entity initiated each transfer. Accordingly, the court held that the trustee’s allegations of transfers of interests of the debtors in property failed to meet the “plausibility” standard imposed post-Iqbal.

The court also found that the trustee made simply the “conclusory assertion” that each alleged preferential transfer was made “for, or on account of, an antecedent debt” owed by the debtor to the defendant before such transfer was made. As a result of the trustee’s failure to demonstrate a number of the prima facie elements of a preferential transfer, the trustee’s preference claims were dismissed.

In addition to preference claims, the trustee in Caremerica also sought to avoid certain alleged actual and constructive fraudulent transfers made within the two-year period prior to the debtor’s petition date. Although allegations of actual fraudulent transfer are generally subject to the heightened pleading standard of Fed. R. Civ. P. 9, claims of constructive fraudulent transfer are subject to the “typical” standard imposed by Fed. R. Civ. P. 8. Nevertheless, the Caremerica I court found the trustee’s claims for actual fraudulent transfer sufficient to survive the defendants’ motion to dismiss, but dismissed those claims arising in constructive fraudulent transfer for lack of plausibility, despite the relatively lower threshold imposed by Rule 8 versus Rule 9.

According to the opinion, the trustee in Caremerica I acknowledged that his claims sounding in actual fraudulent transfer were subject to the pleading standard of Rule 9(b), but argued that the particularity requirement imposed by the rule should be relaxed “because he is a third party with secondhand knowledge and limited access to information at the pleading stage.” The Caremerica I court rejected this argument, holding that a “trustee is certainly more likely to have access to this information than the antitrust plaintiffs in Twombly or the Pakistani detainee in Iqbal.”

The Delphi Case in New York
Against the Caremerica backdrop, bankruptcy decisions applying the Twombly/Iqbal standard to avoidance actions have begun to appear closer to New Jersey.
As of this writing, at least one published decision from U.S. Bankruptcy Court for the District of New Jersey — A-1 Advanced Moving & Storage Inc. v. NorVergence Inc. (In re NorVergence Inc.) — included a Twombly/Iqbal analysis of the plaintiff's allegations. The claims at issue, however, were not fraudulent or preferential transfers or other types of avoidance actions brought under Chapter 5 of the Bankruptcy Code.

In the U.S. Bankruptcy Court for the Southern District of New York, the Twombly/Iqbal pleading standard has recently reared its head in the case of In re DPH Holdings Corp. (Delphi). According to the opinion, Delphi Corp. filed for Chapter 11 bankruptcy in October 2005.

In August 2007, the debtor filed an ex parte motion for permission to file with the bankruptcy court hundreds of avoidance actions under seal, in order to preserve its causes of action under Chapter 5, while at the same time avoiding interruption of its business relationships with many of the defendants. After receiving a number of extensions for time to serve the complaints under Federal Rule of Bankruptcy Procedure 7004, the debtors served the complaints on defendants in 2009 and 2010. Almost immediately, the debtors were faced with dozens of motions to dismiss, alleging that the complaints were of the "threadbare recital" variety, and failed to meet the pleading specifications required under Twombly/Iqbal.

At an omnibus hearing in the Delphi case on July 22, 2010, the court first contemplated whether the Twombly/Iqbal standard should apply to the debtors' complaints, which had been filed — albeit under seal and not served — before the Twombly and Iqbal decisions were rendered. The court concluded that the Twombly/Iqbal standard would apply to the debtors' complaints. The court then held that the debtors' complaints did not meet the applicable pleading standard for a number of reasons, including a failure to identify with specificity which of the nearly 40 debtors was the transferor at issue; the antecedent debt on account of which the transfer at issue was made; and a failure to distinguish among multiple defendants as initial and subsequent transferees. The Delphi court provided the debtors with leave to amend their complaints, offered in September 2010, pending the outcome of the debtors' motion for leave to file such amended complaints. (A hearing on that motion is anticipated to be scheduled for sometime in April or May 2011.)

Although not yet filed, the debtors' proposed amended complaints have already come under attack by multiple defendants on Twombly/Iqbal grounds as it pertains to pleading the elements of a preferential transfer. Among the elements of a preference is that such transfer was made by the debtor while it was insolvent, according to 11 U.S.C. § 547(b)(3). Section 547(f) of the Bankruptcy Code entitles a debtor to a presumption of insolvency for the 90-day period preceding the petition date. However, the Delphi debtors' verified schedules reveal that at approximately the time of filing, the debtors showed a book-value positive net worth of almost $2 billion. In the debtors' proposed amended complaints, they sidestep this contradiction by pleading that "pursuant to Bankruptcy Code section 547(f), for purposes of this Adversary Proceeding, Plaintiff is presumed to have been, and was in fact, insolvent at the time the Transfers were
made." Defendants have already begun to point out that, as pled by the debtors, this recital is merely a legal conclusion and not entitled to the presumption of truth in the wake of *Twombly/Iqbal*.

The *Delphi* case will likely continue as a hotbed of *Twombly/Iqbal* analysis in the context of avoidance actions. Bankruptcy practitioners will surely keep a close eye on the proceedings in the coming months.

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