SECTIONS 548 AND 550—RECENT DEVELOPMENTS IN THE LAW OF FRAUDULENT TRANSFERS AND RECOVERIES

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I. Introduction

Fraudulent transfer avoidance and recovery are principally governed by two independent sections of the Bankruptcy Code,[1] sections 548 and 550, respectively. This Article first provides an introductory discussion of these provisions,[2] and then discusses certain of the cases in 2010 that clarified or otherwise relied on these or similar provisions.

As bankruptcy cases commenced earlier in the decade moved toward their conclusions, many avoidance actions were litigated, making 2010 a busy year for fraudulent transfer actions under the Bankruptcy Code. It was a year of continued scrutiny on the roles of financial institutions, investors and hedge funds leading into the global recession that started late in 2007 and continued through 2009. The impact of the 2009 decision of the Bankruptcy Court for the Southern District of Florida to void, *inter alia*, over

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[1]Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as amended at 11 U.S.C.A. §§ 101 to 1532 (2010) and referred to herein as the "Bankruptcy Code").

[2]Though this Article addresses recent developments in sections 548 and 550, out of necessity, it will also briefly discuss section 544, and other major bankruptcy provisions addressing fraudulent conveyances, including section 546, the Bankruptcy Code section that places certain limits on a trustee's or debtor-in-possession's avoidance powers. *See* 11 U.S.C.A. §§ 544 and 546.

$500 million in upstream guaranties granted by the subsidiaries of TOUSA, Inc. to secure a prepetition refinancing transaction reverberated through the bankruptcy cases.[3] Decisions of note issued in 2010 address the applicability of heighted pleading standards to complaints seeking to avoid fraudulent transfers, the ability of Chapter 15 debtors to commence avoidance actions based on foreign law, and the avoidance of severance payments to former executives made after their insider status ended. High-profile Ponzi scheme cases have been the source of compelling decisions relating to avoidance and recovery of fraudulent transfers and, in particular, addressing the appropriate standards for examining the "good faith" defense included in section 548(c) of the Bankruptcy Code. Of significance at the appellate level, the Fifth Circuit Court of Appeals overruled a district court decision in the case of *In re Condor Ins., Ltd*.[4] to hold that a Chapter 15 foreign representative is authorized to commence avoidance actions based upon foreign law without filing a case under Chapter

[3]*In re TOUSA, Inc.*, 422 B.R. 783 (Bankr. S.D. Fla. 2009), , *overruled in part by* Opinion and Order on Appeals by Transeastern Lenders, *3V In re TOUSA, Inc.*, 444 B.R. 613 (S.D. Fla. 2011). The TOUSA decision was discussed at length in the 2009 version of this Article. Just prior to the completion of this Article, the District Court for the Southern District of Florida in deciding the first of three appeals of the TOUSA decision, quashed the bankruptcy court's ruling and held that settlement payments to the Transeastern Lenders were not fraudulent transfers because (A) the settlement proceeds were not property of the subsidiaries and (B) even if the proceeds were property of the subsidiaries, the subsidiaries received reasonably equivalent value in exchange for granting liens on their assets and (ii) even if the transaction was a fraudulent transfer, the Transeastern Lenders were not entities from whom a fraudulent transfer could be recovered under section 550 of the Bankruptcy Code. Prior to the district court's decision, the bankruptcy court's holding in TOUSA contributed to actions seeking to limit recoveries to prepetition secured lenders based, in part, upon such lenders' troublesome practices, including an over-reliance on subsidiary guaranties. For example, the Bankruptcy Court for the Southern District of Illinois adopted similar reasoning to invalidate a mortgage granted by the debtor principals of a non-debtor corporation to secure a note of the non-debtor corporation. *See also In re Yellowstone Mountain Club, LLC*, 2009 WL 1324950, *5–6 (Bankr. D. Mont. 2009). While not a fraudulent transfer case, the bankruptcy court equitably subordinated the secured lender's claim in the amount of $232 million to other secured, administrative and unsecured claims against the debtors' estates based, in part as in *TOUSA*, on lender's lack of due diligence and the substantial fee income generated by the transaction. *In re Yellowstone Mountain Club, LLC*, 2009 WL 1324950, *5–6 (Bankr. D. Mont. 2009). As in *TOUSA*, the Court found that the bulk of the loan proceeds were distributed and used for purposes unrelated to the borrower. *In re Yellowstone Mountain Club, LLC*, 2009 WL 1324950, *5–6 (Bankr. D. Mont. 2009).

[4]*In re Condor Ins. Ltd.*, 601 F.3d 319, Bankr. L. Rep. (CCH) P 81712 (5th Cir. 2010).

7 or 11 of the Bankruptcy Code. The Fifth Circuit also ruled in *In re Transtexas Gas Corp.*[5] that severance payments to a former CEO made after his departure were avoidable under section 548(a)(1)(B) of the Bankruptcy Code because the former CEO was an insider at the time the payments were arranged. Finally, in a case of first impression, the Seventh Circuit Court of Appeals in *Paloian v. LaSalleBank, N.A.*[6] ruled that a bank, as trustee for holders of asset-securitized pass-through certificates, was an "initial transferee" for purposes of recovery under section 550(a) of the Bankruptcy Code. These and certain other important 2010 fraudulent transfer decisions are addressed in section III. below.

II. Background

Enacted as part of the original 1978 Bankruptcy Reform Act, sections 548 and 550 of the Bankruptcy Code were largely unchanged in their first 20 years. However, in 1998 section 548, which sets forth a trustee's or debtor-in-possession's power to avoid certain prepetition fraudulent transfers and obligations, underwent significant changes in its structure as a result of the enactment of the Religious Liberty and Charitable Donation Protection Act of 1998 (the "Charitable Donation Act")[7] and again in 2005 as a result of the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA").[8]

As further discussed below, section 550, which sets forth the trustee or debtor-in-possession's power to recover the value of avoided transfers, was also significantly amended under the Bankruptcy Amendments and Federal Judgeship Act of 1984 (the

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[5] *In re TransTexas Gas Corp.*, 597 F.3d 298, Bankr. L. Rep. (CCH) P 81684 (5th Cir. 2010).

[6] *Paloian v. LaSalle Bank, N.A.*, 619 F.3d 688, Bankr. L. Rep. (CCH) P 81840 (7th Cir. 2010).

[7] Pub. L. No. 105-183, 112 Stat. 517 (1998), codified at 11 U.S.C.A. § 548(a)(2). For an in-depth discussion of the Charitable Donation Act, *see* Patel, Section 548-Recent Developments in the Law of Fraudulent Transfers, Norton Annual Survey of Bankruptcy Law (1998) page 527.

[8] Pub. L. No 109-8 (2005). BAPCPA was signed into law on April 20, 2005. While BAPCPA was largely effective on October 17, 2005, BAPCPA §§ 1501(a) and 1406(a) were effective only with respect to cases commenced on or after that date. Changes made to section 548 and BAPCPA § 1501(b)(1) were generally effective immediately.

"1984 Amendments"),[9] the Bankruptcy Reform Act of 1994 (the "1994 Reform Act")[10] and BAPCPA.

A. History and Construction of Section 548

Section 548 is derived in large part from section 67(d) of the Bankruptcy Act of 1898.[11] Section 67(d) was codified at section 107(d) of old Title 11, prior to the enactment of the Bankruptcy Code. Its history dates from the Statute of Elizabeth (13 Eliz. c. 5 (1570)). Section 548 consists of four major subsections that set forth the trustee's (or debtor-in-possession's) general powers for avoiding transfers made with the intent to hinder, delay or defraud creditors ("actually fraudulent" transfers) or made while the debtor was insolvent and not in exchange for reasonably equivalent value ("constructively fraudulent" transfers), under section 548(a)(1)[12] as follows:

> The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years, before the date of the filing of the petition, if the debtor voluntarily or involuntarily:
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> (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or
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> (B) (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
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> (ii) (I) was insolvent on the date that such transfer was

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[9] Pub. L. No. 98-353, 98 Stat. 333 (1984).

[10] Pub. L. No. 103-394, 108 Stat. 4106, 4121 (1994) (an attempt to expressly overrule the Seventh Circuit's decision in *Levit v. Ingersoll Rand Financial Corp.*, 874 F.2d 1186, 19 Bankr. Ct. Dec. (CRR) 574, 22 Collier Bankr. Cas. 2d (MB) 36, 11 Employee Benefits Cas. (BNA) 1323, Bankr. L. Rep. (CCH) P 72910 (7th Cir. 1989) .

[11] 30 Stat. 544 (July 1, 1898) (as amended and as subsequently repealed by the Bankruptcy Code, the "Bankruptcy Act"); *see* S. Rep. No. 95-989, 2nd Sess. (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5787.

[12] Because of the renumbering of section 548 that took place with the incorporation of the Charitable Donation Act, care should be taken when researching earlier cases. For example, present section 548(a)(1)(B)(i), the "reasonably equivalent value" provision, was contained in section 548(a)(2)(A) prior to the revisions.

made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;[13]

(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; or

(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.

The prefatory paragraph of section 548(a)(1) generally gets much less attention by the courts than the subtest provisions of section 548(a)(1)(A) and (B). BAPCPA, however, made two changes to the prefatory paragraph.[14]

The first change relates to the broader change discussed below relating to employment contracts as a fourth subtest for reasonably equivalent exchange. As "transfer" is already broadly defined

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[13]The question as to who bears the burden of solvency versus insolvency has been addressed by one court under unusual circumstances. In *Eerie World*, a defendant moved for summary judgment on this issue in a trial that lasted for years. *Eerie World Entertainment, L.L.C. v. Bergrin*, 2004 WL 2712197, *2–3 (S.D. N.Y. 2004). The plaintiff's response was to rest on the allegations in the pleadings, arguing that solvency was a question of fact, not law. The court in *Eerie World* found that while solvency was a question of fact ordinarily reserved for a jury, as a response to a summary judgment motion in such a case, resting on the pleadings was entirely inappropriate and warranted judgment in the defendant's favor. Pleading standards are discussed in greater detail in section III.B. of this Article.

[14]In addition to direct changes, BAPCPA also changed other Bankruptcy or United States Code provisions governing actions under section 548. The first such change relates to the venue of avoidance actions. *See* 28 U.S.C.A. § 1409(a). While this section has been referred to by some as the preference venue statute, it is not limited to preferences and, on its face, would apply to fraudulent transfer recovery actions as well. Generally, unless *de minimus,* all such actions may be brought where the bankruptcy case itself is venued. For *de minimus* actions, however, BAPCPA dictates that such cases may be brought only in the district in which the defendant resides.

BAPCPA also changed the thresholds regarding such *de minimus* actions. Prior to its enactment, such actions were delineated as ones "to recover a money judgment of or property worth less than $1,000 or a consumer debt of less than $5,000." BAPCPA changes the consumer debt threshold to $15,000 and adds a new threshold of $10,000 for debts (excluding consumer debts) against non-insiders. 28 U.S.C.A. § 1409.

in the Bankruptcy Code,[15] the addition of "including any transfer to or for the benefit of an insider under an employment contract" after the word "transfer" in section 548(a)(1) arguably does nothing other than send a message to the public from Congress that it understands there is a perceived problem in this realm (something Congress could just as easily have done in the legislative history to BAPCPA).

The second change altered the look-back period in section 548 from one to two years.[16] Unlike the majority of changes to section 548, the change to the look-back period was applicable "only with respect to cases commenced . . . more than one year after the date of the enactment of [BAPCPA]."[17] Because BAPCPA was signed into law in April 20, 2005, the change to the look-back period became effective on and is applicable to cases commenced on or after April 20, 2006. The two-year limitation in this section is augmented by the operation of section 546(a) of the Bankruptcy Code[18] and section 544(b) of the Bankruptcy Code,[19] the latter of which allows the trustee to bootstrap into state fraudulent

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[15]11 U.S.C.A. § 101(54).

[16]*See* 11 U.S.C.A. §§ 548(a)(1) and 548(b).

[17]BAPCPA § 1406(b)(2). For a case that affirms the timing element, and also considers a number of other statute of limitations, relation back and related principles, *see In re Circle Y of Yoakum, Texas*, 354 B.R. 349, 47 Bankr. Ct. Dec. (CRR) 117 (Bankr. D. Del. 2006).

[18]Section 546 provides in relevant part as follows:

> (a) An action or proceeding under section 544, 545, 547, 548, or 553 of this title may not be commenced after the earlier of-
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> (1) the later of-
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> (A) 2 years after the entry of the order for relief; or
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> (B) 1 year after the appointment or election of the first trustee under section 702, 1104, 1163, 1202, or 1302 of this title if such appointment or such election occurs before the expiration of the period specified in subparagraph (A)

11 U.S.C.A. § 546(a)(1). A recent case examined the two-year look-back period of section 546(a). *See In re Raynor*, 617 F.3d 1065, 1071, 63 Collier Bankr. Cas. 2d (MB) 1765, Bankr. L. Rep. (CCH) P 81836 (8th Cir. 2010), cert. denied, 131 S. Ct. 945, 178 L. Ed. 2d 756 (2011) (holding that "the plain language of § 546(a) provides that a complaint filed on the two-year anniversary of the entry of the order for relief . . . is not time barred").

[19]Section 544(b)(1) provides as follows:

> Except as provided in paragraph (2), the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title.

conveyance law, which in turn can offer a look-back period of four or more years.[20]

The majority of the attention paid by the courts to section 548(a) is to the subtests in section 548(a)(1)(A) and section 548(a)(1)(B)—the so-called "actual" and "constructive" fraud tests, respectively.[21] With respect to the former, several cases discuss so-called "badges of fraud" in the context of circumstantial evidence of such intent.[22]

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11 U.S.C.A. § 544(b)(1). In a 2009 bankruptcy court decision, the court concluded that the Federal look-back period under section 548(a)(1)(A) does not preempt the applicable state fraudulent transfer look-back period. *In re Supplement Spot, LLC*, 409 B.R. 187, 197–99 (Bankr. S.D. Tex. 2009).

[20]All but a handful of states have adopted the Uniform Fraudulent Transfers Act ("UFTA"), which provides that for fraudulent transfers made with actual intent, the look-back period is either four years, or one year after the transfer or obligation was or could have reasonably been discovered by the claimant, whichever is greater. *See* UFTA § 9(a); *accord In re Maine Poly, Inc.*, 317 B.R. 1, 7–12 (Bankr. D. Me. 2004) (the court examined both Maine's UFTA and section 548 to determine that the parent corporation's receipt of debt cancellation as part of an asset sale was affected with no actual intent to hinder, delay, or defraud creditors). Maryland, New York, Tennessee, the U.S. Virgin Islands and Wyoming have not adopted the UFTA.

[21]*See In re Hannover Corp.*, 310 F.3d 796, 799, 40 Bankr. Ct. Dec. (CRR) 116, 49 Collier Bankr. Cas. 2d (MB) 1061, Bankr. L. Rep. (CCH) P 78741 (5th Cir. 2002); *Frierdich v. Mottaz*, 294 F.3d 864, 870–71, 39 Bankr. Ct. Dec. (CRR) 210, Bankr. L. Rep. (CCH) P 78674, 47 U.C.C. Rep. Serv. 2d 1451 (7th Cir. 2002) (trustee can prove actual intent to defraud by circumstantial evidence, such as whether the debtor retained control of the property after the transfer, whether he had a close relationship with the transferee, whether he received consideration for the transfer and whether he made the transfer before or after being threatened with suit by his creditors); *cf. In re Erlewine*, 349 F.3d 205, 211–13, 42 Bankr. Ct. Dec. (CRR) 12, Bankr. L. Rep. (CCH) P 78938 (5th Cir. 2003) (despite description of division of property contained therein as "disproportionate," court required a showing of actual fraud before failing to give comity to state divorce decree). As discussed in more detail below, the distinction between the actual and constructive fraud sections becomes a determinative factor with respect to a number of rights and remedies (*e.g.*, with respect to the trustee's or debtor-in-possession's limitations on avoidance contained in section 546 of the Bankruptcy Code).

[22]*See, e.g., In re Bayou Group, LLC*, 439 B.R. 284, 307 (S.D. N.Y. 2010) ("*Bayou IV*") (payments to investors in the fund operated as a Ponzi scheme were accompanied by numerous "badges of fraud" sufficient to imply actual intent to defraud on the part of the fund's principals) (*Bayou IV* is discussed at length in section III.A.1. of this Article.); *Adelphia Recovery Trust v. Bank of America, N.A.*, 624 F. Supp. 2d 292, 334–35 (S.D. N.Y. 2009), reconsideration granted in part, 2009 WL 1676077 (S.D. N.Y. 2009) (margin lenders had reason to believe Adelphia insolvent but continued to accept loan payments in order to keep margin lending facilities open, thus prolonging fraud); *ASARCO LLC v.*

Additionally, there are numerous cases discussing what does or does not constitute "reasonably equivalent value" under section 548(a)(1)(B)(i) and the standards or proof for establishing such value.[23] As noted above, however, BAPCPA has added more to

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Americas Mining Corp., 396 B.R. 278 (S.D. Tex. 2008) (court found actual intent to hinder, delay and defraud creditors by a preponderance of the evidence after examining "badges of fraud" and other circumstantial evidence that demonstrated knowledge that transaction as structured would hinder, delay and defraud some creditors despite the legitimate business purpose of payment of a security interest); *In re Bernard L. Madoff Inv. Securities, LLC*, 440 B.R. 243, 259 n.18, 64 Collier Bankr. Cas. 2d (MB) 957 (Bankr. S.D. N.Y. 2010) (noting that many courts examine "badges of fraud" as a means of determining fraudulent intent based on circumstantial evidence) (citing *In re Saba Enterprises, Inc.*, 421 B.R. 626, 643 (Bankr. S.D. N.Y. 2009)) (*Picard v. Merkin* is discussed at length in section III.A.2. of this Article); *In re Phillips*, 379 B.R. 765, 778 (Bankr. N.D. Ill. 2007) (cumulative effect of presence of numerous "badges of fraud" together with trustee's direct evidence was probative of actual intent); *In re MarketXT Holdings Corp.*, 376 B.R. 390, 405 (Bankr. S.D. N.Y. 2007) ("[b]adges of fraud are circumstances so commonly associated with fraudulent transfers that their presence gives rise to an inference of intent, and they are allowed as proof due to the difficulty of proving actual intent to hinder, delay or defraud creditors." (quotations omitted)); *In re Knippen*, 355 B.R. 710, 721–22 (Bankr. N.D. Ill. 2006), judgment aff'd, 2007 WL 1498906 (N.D. Ill. 2007) ("[b]ecause there is rarely direct evidence of the intent underlying a transfer of property, courts look to circumstantial evidence, referred to as the badges of fraud, in determining whether a transfer was intended to hinder, delay, or defraud creditors"); *In re Cassandra Group*, 338 B.R. 583, 598 (Bankr. S.D. N.Y. 2006) ("[r]ecognizing that it is typically difficult to demonstrate intent by direct evidence, the courts have identified various badges of fraud that serve as circumstantial evidence of actual intent"); *cf. In re Triple S Restaurants, Inc.*, 422 F.3d 405, 414–16, 45 Bankr. Ct. Dec. (CRR) 57, Bankr. L. Rep. (CCH) P 80348, 2005 FED App. 0371P (6th Cir. 2005) (discussing, among various other factors, the "badges of fraud" inherent in the transactions); *In re McCarn's Allstate Finance, Inc.*, 326 B.R. 843, 849–50, 44 Bankr. Ct. Dec. (CRR) 275 (Bankr. M.D. Fla. 2005) (courts look to "badges of fraud" to determine if circumstantial evidence supports an inference of intent to perpetrate actual fraud); *In re Park South Securities, LLC.*, 326 B.R. 505, 517–18 (Bankr. S.D. N.Y. 2005) (due to a trustee's status as an outsider, courts will accept allegations of circumstantial evidence to establish fraudulent intent, including "badges of fraud").

[23] *See, e.g.*, *In re Kendall*, 440 B.R. 526, 532–33, 64 Collier Bankr. Cas. 2d (MB) 1404, Bankr. L. Rep. (CCH) P 81898 (B.A.P. 8th Cir. 2010) (the question of receipt of reasonably equivalent value is a factual determination) (citing *In re Ozark Restaurant Equipment Co., Inc.*, 850 F.2d 342, 344, 17 Bankr. Ct. Dec. (CRR) 1321, 19 Collier Bankr. Cas. 2d (MB) 35, Bankr. L. Rep. (CCH) P 72344 (8th Cir. 1988)); *In re TriGem America Corp.*, 431 B.R. 855, 867 (Bankr. C.D. Cal. 2010) (indirect benefits can suffice as reasonably equivalent value "if they are 'fairly concrete and identifiable.' ") (citing *In re TOUSA, Inc.*, 422 B.R. 783, 846–50 (Bankr. S.D. Fla. 2009), ; *In re Goldstein*, 428 B.R. 733, 736, 64 Collier Bankr. Cas. 2d (MB) 202 (Bankr. W.D. Mich. 2010) (holding the same); *Grocho-*

this already complex provision by adding a fourth subtest—one specifically targeted at employment contracts. This addition of the fourth subtest is the second change to section 548 with respect to insiders under employment contracts.[24]

These employment contract changes are set forth in BAPCPA in the Title named "Preventing Corporate Bankruptcy Abuse."[25]

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cinski v. Schlossberg, 402 B.R. 825, 835 n.7 (N.D. Ill. 2009) (issue of reasonably equivalent value is an element of the prima facie case to prove fraud in law) (citing *General Elec. Capital Corp. v. Lease Resolution Corp.*, 128 F.3d 1074, 1079, 47 Fed. R. Evid. Serv. 1074 (7th Cir. 1997)); *In re EBC I, Inc.*, 356 B.R. 631, 642, 47 Bankr. Ct. Dec. (CRR) 131 (Bankr. D. Del. 2006) (to the extent the debtor paid more to defendant than the value of the services received, the termination of the contract eliminated that value, and thus the debtor received less than reasonably equivalent value); In re Knippen, 355 B.R. at 726 (the determination of "reasonably equivalent value" under section 548(a)(1)(B) is a two-step process where the court must first determine whether the debtor received value, and then examine whether the value is reasonably equivalent to what the debtor gave up); *In re Terry Mfg. Co., Inc.*, 358 B.R. 429, 434, 47 Bankr. Ct. Dec. (CRR) 110 (Bankr. M.D. Ala. 2006) ("reasonably equivalent value" is a fact-intensive question, not generally appropriate for summary judgment); *see also In re Northern Merchandise, Inc.*, 371 F.3d 1056, 1058–59, 43 Bankr. Ct. Dec. (CRR) 49, Bankr. L. Rep. (CCH) P 80112 (9th Cir. 2004) (finding reasonably equivalent value in return for security interests granted by debtor to secure loan to shareholders, when debtor actually benefited from the loan); *Pension Transfer Corp. v. Beneficiaries Under Third Amendment To Fruehauf Trailer Corporation Retirement Plan No. 003*, 319 B.R. 76, 86, 34 Employee Benefits Cas. (BNA) 1361 (D. Del. 2005), aff'd, 444 F.3d 203, 46 Bankr. Ct. Dec. (CRR) 100, 37 Employee Benefits Cas. (BNA) 1796, Bankr. L. Rep. (CCH) P 80483 (3d Cir. 2006) (the opportunity to receive economic benefit in the future is "value" under the *In re Denison*, 292 B.R. 150, 154–55 (E.D. Mich. 2003) (contractual rights to future consideration can provide reasonably equivalent value); *In re Solomon*, 300 B.R. 57, 64–7 (Bankr. N.D. Okla. 2003), order aff'd, 299 B.R. 626 (B.A.P. 10th Cir. 2003) (concluding that, by operation of law, securing antecedent debt provides value to the debtor, but that nonetheless such value was not reasonably equivalent value because, even if the lender did "provide some small measure of forbearance in exchange for the mortgages," the deprivation of property from the debtors' other creditors made the transaction overall lack reasonably equivalent value); *In re Dayton Title Agency, Inc.*, 292 B.R. 857, 874–75, 50 U.C.C. Rep. Serv. 2d 1164 (Bankr. S.D. Ohio 2003) (previous payment into a trust account of loan proceeds did not constitute reasonably equivalent value for funds subsequently paid to the depositor because the loan proceeds were previously disbursed by the trust account and the subsequent transfer caused the trust account to have a negative balance, and in so doing rejecting as unquantified the defendant's claims that "goodwill and the continuation of business relationships" can be indirect benefits to be considered in a determination of reasonably equivalent value).

[24]The first change, discussed above, did little to expand an already expansive definition of transfer in these provisions.

[25]BAPCPA at Title XIV.

This second change has more teeth than the first, but may result in a lessening of the preventive nature of section 548 in this regard because the inclusion of a subtest specifically addressing transfers under employment contracts with respect to insiders[26] may actually act to bar recovery in such instances. By including such a provision in the constructive fraud section in the manner dictated in BAPCPA, Congress first requires such transfers to be for less than reasonably equivalent value, a subject of much debate. Further, the "not in the ordinary course" language included in the subtest may prove difficult to satisfy.[27]

Section 548 contains a number of provisions *other than* the actual and constructive fraud provisions in section 548(a)(1). Section 548(a)(2), for example, codifies the Charitable Donation Act, as follows:

> (a) (2) A transfer of a charitable contribution to a qualified religious or charitable entity or organization shall not be considered to be a transfer covered under paragraph (1)(B) in any case in which-
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> (A) the amount of that contribution does not exceed 15 percent of the gross annual income of the debtor for the year in which the transfer of the contribution is made;[28] or
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> (B) the contribution made by a debtor exceeded the percentage amount of gross annual income specified in subparagraph (A), if the transfer was consistent with the practices of the debtor in making charitable contributions.

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[26] 11 U.S.C.A. § 548(a)(1)(B)(ii)(IV) (deeming constructively fraudulent and avoidable transfers made or obligations incurred for less than reasonably equivalent value "to or for the benefit of an insider, under an employment contract and not in the ordinary course of business").

[27] Two recent decisions, discussed at length in section III.C. of this Article, hold that severance payments to former insiders were constructively fraudulent, indicating the courts may not have trouble finding such arrangements outside of the ordinary course. *See In re TransTexas Gas Corp.*, 597 F.3d 298, Bankr. L. Rep. (CCH) P 81684 (5th Cir. 2010); *In re TSIC, Inc.*, 428 B.R. 103 (Bankr. D. Del. 2010).

[28] One court determined that where a debtor has a sole proprietorship business, the debtor's "gross income" for purposes of calculating charitable contributions under section 548(a)(2) shall be the debtor's gross receipts, without subtracting the cost of goods or operating expenses. *In re Lewis*, 401 B.R. 431, 445, 61 Collier Bankr. Cas. 2d (MB) 1051, Bankr. L. Rep. (CCH) P 81452 (Bankr. C.D. Cal. 2009).

The Charitable Donation Act also amended section 544, preempting any attempt to use that section to avoid a charitable donation otherwise protected under section 548(a)(2).[29]

Bankruptcy courts have reviewed the plain meaning of the section, and concluded that the 15% limitation in section 548(a)(2)(A) is in essence a qualifying criterion for a transfer, not a measuring device for propriety.[30] Thus, if a transfer exceeds the 15% mark, even by a penny, the entire transfer will not be afforded the protections of section 548(a)(2)(A).[31] Another problem with section 548(a)(2) is that, as drafted, the provision applies to single transfers.[32] Thus, while a single transfer in and of itself may not exceed the limitation, aggregated transfers within a single year may do so and the language of this section calls into question whether they would still be afforded protection. A court that considered what was required for a transfer to be "consistent with the practices of the debtor" determined that a $20,000 donation was inconsistent with practices when the largest previous donation was $2,000, and exceeded annual cumulative donations in past years.[33] One should also note that in order to invoke the

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[29]Section 544 now provides as follows:

> Paragraph (1) shall not apply to a transfer of a charitable contribution (as that term is defined in section 548(d)(3)) that is not covered under section 548(a)(1)(B), by reason of section 548(a)(2). Any claim by any person to recover a transferred contribution described in the preceding sentence under Federal or State law in a Federal or State court shall be preempted by the commencement of the case.

11 U.S.C.A. § 544(b)(2). As stated by the Ninth Circuit Bankruptcy Appellate Panel, "with the 1998 [Charitable Donation] Act, Congress unequivocally established the priority of charitable contributions. The clear and unmistakable message is that the interests of creditors are subordinate to the interests of charitable organizations, and we must follow this mandate." *In re Cavanagh*, 250 B.R. 107, 113, 36 Bankr. Ct. Dec. (CRR) 100, Bankr. L. Rep. (CCH) P 78233 (B.A.P. 9th Cir. 2000) (using section 548(a)(2) to provide guidance for a Chapter 13 plan).

[30]*In re Zohdi*, 234 B.R. 371, 374–84, 34 Bankr. Ct. Dec. (CRR) 609, 42 Collier Bankr. Cas. 2d (MB) 453 (Bankr. M.D. La. 1999); *see also In re Witt*, 231 B.R. 92, 97–100, 34 Bankr. Ct. Dec. (CRR) 22 (Bankr. N.D. Okla. 1999) (finding section 548(a)(2) to be constitutional).

[31]But it still may be afforded protection under section 548(a)(2)(B), if applicable. *See* In re Zohdi, 234 B.R. at 374–85.

[32]In re Zohdi, 234 B.R. at 380 n.20.

[33]*In re Jackson*, 249 B.R. 373, 377 (Bankr. D. N.J. 2000).

protections of the Charitable Donation Act in this regard, the debtor must be a "natural person."[34]

Section 548(b) sets out the avoidance powers by the trustee of a partnership debtor of transfers to general partners of the debtor,[35] and is rarely litigated.[36]

Section 548(c) contains a "savings clause" that protects transferees who would otherwise be subject to section 548 avoidance if they took "for value and in good faith" by granting such transferees lien rights, retained interests or enforcement rights, as the case may be, with respect to the interest transferred or obligation incurred to the extent that the transferees gave value to the debtor in exchange for such transfer or obligation.[37] Section 548(c) has been the topic of much litigation.[38]

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[34]11 U.S.C.A. § 548(d)(3)(A); *Universal Church v. Geltzer*, 463 F.3d 218, Bankr. L. Rep. (CCH) P 80725, 36 A.L.R. Fed. 2d 649 (2d Cir. 2006); *In re C.F. Foods, L.P.*, 280 B.R. 103, 111 n.17 (Bankr. E.D. Pa. 2002).

[35]Section 548(b) provides:

> The trustee of a partnership debtor may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, to a general partner in the debtor, if the debtor was insolvent on the date such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation.

11 U.S.C.A. § 548(b).

[36]*See In re Labrum & Doak, LLP*, 227 B.R. 383, 386–87, 33 Bankr. Ct. Dec. (CRR) 598 (Bankr. E.D. Pa. 1998) (dissolved law firm general partners who received payments otherwise in violation of section 548(b) may retain the payments if the criteria of section 548(c) savings clause are met); *In re 1634 Associates*, 157 B.R. 231, 233–34, 24 Bankr. Ct. Dec. (CRR) 957 (Bankr. S.D. N.Y. 1993) (holding that section 548(b) applies to indirect transfers made for the benefit of general partners); *see also In re Prime Realty, Inc.*, 380 B.R. 529, 537 n.2, 49 Bankr. Ct. Dec. (CRR) 71 (B.A.P. 8th Cir. 2007) (finding that the debtor's long-term obligations to its limited partners pursuant to purchase contracts were not considered liabilities on its balance sheet in its insolvency analysis).

[37]Section 548(c) provides:

> Except to the extent that a transfer or obligation voidable under this section is voidable under section 544, 545, or 547 of this title, a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

11 U.S.C.A. § 548(c).

[38]*See* Bayou IV, 439 B.R. at 308 (a transferee bears the burden of "proving that it took: (1) 'for value . . . to the extent that [it] gave value' to the debtor in exchange for such transfer and (2) 'in good faith.' ") (*Bayou IV* is discussed at length in section III.A.1. of this Article); *In re Hill*, 342 B.R. 183, 203 (Bankr. D.

Section 548(d) amounts to what is essentially a subsection containing definitions used in the section, and is too lengthy to set forth herein in its entirety.[39] Except for the safe harbor provision litigated on several occasions in 2001,[40] section 548(d) is rarely the subject of litigation.[41]

N.J. 2006) (utilization of the good faith defense requires proof of two elements: first, innocence on the part of the transferee, and second, an exchange of value); *see also* In re Northern Merch., Inc., 371 F.3d at 1060 (finding good faith where a loan incurred by a debtor's shareholders for the benefit of the debtor was secured with corporate assets, as value given to the debtor's estate); *In re Foxmeyer Corp.*, 296 B.R. 327, 341–42, 41 Bankr. Ct. Dec. (CRR) 225 (Bankr. D. Del. 2003) (good faith determination survives a motion for judgment as a matter of law); *In re H. King & Associates*, 295 B.R. 246, 285–86 (Bankr. N.D. Ill. 2003) (holding that section 548(c), not section 550(b), is the appropriate and sole good faith defense for initial transferees of fraudulent conveyances). It is not necessarily dispositive that a transaction be entered into at arm's length. *See In re e2 Communications, Inc.*, 320 B.R. 849, 858, 43 Bankr. Ct. Dec. (CRR) 277 (Bankr. N.D. Tex. 2004) (Stating that "how arm's-length negotiations leading up to the execution of the [agreement] is relevant to this avoidance action is not explained by the Defendant. The Court sees little, if any, relevance at this time. Rather, what is relevant to a fraudulent transfer claim is the Debtor's intent in entering into the transaction . . ."). *But see In re Jones*, 304 B.R. 462, 475–76, 51 Collier Bankr. Cas. 2d (MB) 874 (Bankr. N.D. Ala. 2003) (finding good faith in an arm's-length pawn transaction even though the debtor received far less than reasonably equivalent value in the transaction).

[39]BAPCPA changed section 548(d) in a manner consistent with the changes to section 546 noted below, namely to include "financial participants" to the general protections contained in section 548(d)(2)(B)-(D) (creating statutory definitions of when a transfer is "for value" with respect to certain securities transactions). Similarly, BAPCPA added a new section 548(d)(2)(E) which included, in parallel to the addition of section 546(j), "master netting agreements" to those transfers that are statutorily "for value."

[40]*In re Adler, Coleman Clearing Corp.*, 263 B.R. 406, 480–85, 44 U.C.C. Rep. Serv. 2d 1125 (S.D. N.Y. 2001); *In re Paramount Citrus, Inc.*, 268 B.R. 620, 624–26 (M.D. Fla. 2001) (section 548(d)(2)(B) cannot be used to shelter a transfer unless the debtor itself had an account with the commodity broker). On the opposite end of the spectrum from the safe harbor provisions, there is a question as to whether a committee or trustee pursuing a fraudulent transfer action is subject to defenses arising from the debtor's fraudulent conduct. *In re Personal and Business Ins. Agency*, 334 F.3d 239, 41 Bankr. Ct. Dec. (CRR) 134, Bankr. L. Rep. (CCH) P 78871 (3d Cir. 2003) (Chapter 7 trustee not subject to defenses when bringing action under section 548.), *with Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340, 359–60, 38 Bankr. Ct. Dec. (CRR) 147 (3d Cir. 2001) (committee subject to defenses when bringing an action under section 541).

[41]*Frierdich v. Mottaz*, 294 F.3d 864, 867, 39 Bankr. Ct. Dec. (CRR) 210, Bankr. L. Rep. (CCH) P 78674, 47 U.C.C. Rep. Serv. 2d 1451 (7th Cir. 2002) (definition of "transfer" under section 548(d)(1)); *see also Anand v. National Republic Bank of Chicago*, 239 B.R. 511, 517, 42 Collier Bankr. Cas. 2d (MB)

BAPCPA added section 548(e) to address asset protection trusts. Under section 548(e), a trustee can avoid a debtor's transfer of an interest in property made within 10 years of the filing if the transfer was made to a self-settled trust or similar device by the debtor for the benefit of the debtor and the transfer was made with the actual intent to hinder, delay or defraud any creditor. This section is targeted at persons who seek to use self-settled trusts to avoid paying creditors. Commonly referred to as the "millionaire's loophole,"[42] the change was intended to curb the move by several states to exempt such self-settled trusts from bankruptcy treatment. The methodology of section 548(e) stems from the language of section 541 of the Bankruptcy Code (the statute defining property of a debtor's estate).[43] Under section 541(c)(2), restrictions on the transfer of beneficial interests in trusts that are "enforceable under applicable nonbankruptcy law" are made enforceable in a bankruptcy case (thereby causing such property to be excluded from the debtor's bankruptcy estate).[44] Five states (Alaska, Delaware, Nevada, Rhode Island and Utah) enacted such laws between 1997 and the implementation of BAPCPA.[45] Rather than revise section 541, however, Congress chose instead to alter the application of section 548. As implemented, section 548(e) reads as follows:

> (e) (1) In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if:
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> (A) such transfer was made to a self-settled trust or similar device;
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> (B) such transfer was by the debtor;
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> (C) the debtor is a beneficiary of such trust or similar device; and

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1528 (N.D. Ill. 1999) (while collateralization of an antecedent debt may afford the debtor reasonably equivalent value under section 548(a)(l)(B)(i), reasonably equivalent value must be determined on a case-by-case basis).

[42]The language in section 548(e) was chosen over competing changes introduced in the House of Representatives under the somewhat inflammatory title of the "Billionaire's Loophole Elimination Act." H.R. 1278, 109th Cong., 1st Sess. (Mar. 14, 2005).

[43]11 U.S.C.A. § 541(c)(2).

[44]Gretchen Morgenson, *Proposed Law on Bankruptcy Has Loophole*, N.Y. Times, March 2, 2005.

[45]Gretchen Morgenson, *Proposed Law on Bankruptcy Has Loophole*, N.Y. Times, March 2, 2005.

> (D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.
>
> (2) For the purposes of this subsection, a transfer includes a transfer made in anticipation of any money judgment, settlement, civil penalty, equitable order, or criminal fine incurred by, or which the debtor believed would be incurred by:
>
> (A) any violation of the securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47))), any State securities laws, or any regulation or order issued under Federal securities laws or State securities laws; or
>
> (B) fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any security registered under section 12 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78l and 78o(d)) or under section 6 of the Securities Act of 1933 (15 U.S.C. 77f).

The result is that a trustee can avoid a debtor's transfer of an interest in property made within 10 years of the filing if the transfer was made to a self-settled trust or similar device by the debtor for the benefit of the debtor and the transfer was made with the actual intent to hinder, delay or defraud any creditor.[46]

BAPCPA also made a number of changes to the treatment of

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[46]It should be noted that, unlike the changes with respect to insider transfers, this change is somewhat elegant in nature. By permitting the trustee to avoid the transfer to the trust (or similar device), Congress need not engage in tricky rulemaking with respect to section 541(c)(2). States remain free to protect such trusts but, if the transfers are fraudulent, the trust may be deemed to fail regardless. As with most of the changes to section 548, section 548(e) was effective immediately upon enactment to cases commenced on or after that date. The impact of these changes on section 548(e) appears to have only been discussed meaningfully in one case. *See In re Potter*, 2008 WL 5157877, *8 (Bankr. D. N.M. 2008) (holding that section 548(e) applied to a trust even when the debtor was one of multiple beneficiaries and that transfers by a limited liability company to the trust were considered "by" the debtor when he was the sole member of the limited liability company); *see also In re Combes*, 382 B.R. 186, 193–94 (Bankr. E.D. N.Y. 2008) (court declined to address whether the purchase of an annuity could constitute a transfer to a "self-settled trust or similar device" under section 548(e); however, the court held that in order to avoid a transfer pursuant to § 548(e)(1) the trustee must commence an adversary proceeding); *In re Gould*, 348 B.R. 78, 80 n.18, Bankr. L. Rep. (CCH) P 80720 (Bankr. D. Mass. 2006) (discussing section 548(e) as a statutory interpretation example unrelated to its actual content); *In re Cherry*, 2006 WL 3088212, *25

financial contracts, as such are governed by section 548 and related sections of the Bankruptcy Code. Though not part of the overarching purpose of BAPCPA, these changes are part of an entire Title of BAPCPA devoted to harmonizing the conflicting treatment of financial contracts in the Bankruptcy Code with various other federal laws (*e.g.*, the Federal Deposit Insurance Act, the Federal Credit Union Act, the Federal Deposit Insurance Corporation Improvement Act of 1991 and the Securities Investor Protection Act) and federal regulations (*e.g.*, by the FDIC, the SEC, the NCUAB and the Federal Reserve).

Under these provisions, transfers that are margin or settlement payments made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency,[47] or to a repurchase participant or financial participant, in connection with a repurchase agreement[48] may only be avoided if actually fraudulent under section 548(a)(1)(A), but not if merely constructively fraudulent under section 548(a)(1)(B). The same applies to transfers made by or to a swap participant or financial participant under or in connection with any swap agreements[49] and transfers made by or to a master netting participant under or in connection with any master netting agreement or any individual contract covered thereby.[50]

As those changes relate to section 548, they include the addition of "financial participants" to the various financial contract

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(Bankr. S.D. Tex. 2006) (denying standing to third-party plaintiffs to bring an action under section 548(e), stating that "[t]hese claims belong to the Trustee").

[47]11 U.S.C.A. § 546(e) (BAPCPA added "financial participant" to this group). Section 546(e) provides:

> Notwithstanding [s]ections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in [s]ection 101, 741, or 761 of this title, or settlement payment as defined in [s]ection 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in [s]ection 741(7), commodity contract, as defined in [s]ection 761(4), or forward contract, that is made before the commencement of the case, except under [s]ection 548(a)(1)(A) of this title.

[48]11 U.S.C.A. § 546(f) (BAPCPA added "financial participant" to this group.).

[49]11 U.S.C.A. § 546(g) (BAPCPA also added "financial participant" to this group and changed the wording of this provision.).

[50]11 U.S.C.A. § 546(j) (newly added by BAPCPA).

parties who may be deemed to take for value under section 548(d)(2)[51] and the inclusion of "master netting agreements" to the various types of financial contracts afforded the same protection.[52]

The former change protects parties with transactions with a total gross dollar value of at least $1 billion in notional or actional principal amount or gross mark-to-market positions of at least $100 million (aggregated across counterparties) in one or more agreements or transactions, in any day during the previous 15-month period.[53] As noted by the FDIC, "these changes will reduce systemic risk by providing greater clarity to the rights available to larger participants in markets."[54] The latter change parallels the addition of new section 561 of the Bankruptcy Code, clarifying the ability of counterparties to net payments across different categories of financial contracts[55] by making it clear that such netting may be for value under section 548(d)(2).

The treatment of financial contracts was further modified by the passage of the Financial Netting Improvement Act of 2006 (the "Act of 2006")[56] which, among other things, clarified the types of transfers and payments that are subject to the statutory safe harbor from avoidance actions provided by section 546(e) of the

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[51] *See* 11 U.S.C.A. § 548(d)(2)(B)-(D) (each adding "financial participants" to those who may take "for value" under certain financial contracts); *see also* 11 U.S.C.A. § 101(22A) (defining "financial participant"). *Cf.* 11 U.S.C.A. § 546(e) to (g) (same).

[52] 11 U.S.C.A. § 548(d)(2)(E) (stating that "a master netting agreement participant that receives a transfer in connection with a master netting agreement or any individual contract covered thereby takes for value to the extent of such transfer, except that, with respect to a transfer under any individual contract covered thereby, to the extent that such master netting participant otherwise did not take (or is otherwise not deemed to have taken) such transfer for value").

[53] 11 U.S.C.A. § 101(22A) (defining "financial participant").

[54] *See* Michael H. Krimminger, *Adjusting the Rules: What Bankruptcy Reform Will Mean for Financial Market Contracts*, FYI: An Update on Emergency Issues on Banking, *at* http://www.fdic.gov/bank/analytical/fyi/2005/101105fyi.html (last modified October 11, 2005).

[55] *See* 11 U.S.C.A. § 561; *see also* 11 U.S.C.A. §§ 101(38A) (defining "master netting agreement") and 101(38B) (defining "master netting agreement participant").

[56] *See* Financial Netting Improvements Act of 2006, Pub. L. No. 109-390, § 5 (2006).

Bankruptcy Code.[57] The updates and revisions to the descriptions of certain financial transactions were intended to better reflect current market and regulatory industry practice. Notably, in addition to margin and settlement payments, which were already protected under section 546(e), the Act of 2006 expanded this provision to encompass transfers made to or for the benefit of a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant or securities clearing agency in connection with any securities, commodities or forward contracts. The Act of 2006 also expanded the section 546(e) safe harbor to include swap and repurchase agreement participants by virtue of amending certain definitional provisions of the Bankruptcy Code.[58]

Finally, BAPCPA granted specific powers to foreign representatives under Chapter 15 of the Bankruptcy Code to invoke and utilize the power to avoid fraudulent transfers under section

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[57]Pub. L. 109-390 (2006). The Financial Netting Improvement Act of 2006 also amends provisions of the Bankruptcy Code to conform with parallel provisions in the Federal Deposit Insurance Act and the Federal Credit Union Act.

[58]Section 546(e) of the Bankruptcy Code insulates "margin payments" and "settlement payments" made to or by a broker or financial institution from challenge as fraudulent transfers, absent a showing of actual fraudulent intent. "Settlement payments" are defined by section 741(8) of the Bankruptcy Code, in substance, as settlement payments or similar payments commonly used in the securities trade. *See* note 47 for the language of section 546(e). Several decisions, discussed in section III.C.2. of the 2009 version of this Article, address the avoidance of payments and transfers made in connection with leveraged buyouts as fraudulent transfers and whether such payments fall within the safe harbor of section 546(e). *See, e.g., In re Plassein Intern. Corp.*, 590 F.3d 252, 52 Bankr. Ct. Dec. (CRR) 145, Bankr. L. Rep. (CCH) P 81653 (3d Cir. 2009), cert. denied, 130 S. Ct. 2389, 176 L. Ed. 2d 769 (2010); *In re QSI Holdings, Inc.*, 571 F.3d 545, 51 Bankr. Ct. Dec. (CRR) 222, Bankr. L. Rep. (CCH) P 81528 (6th Cir. 2009), cert. denied, 130 S. Ct. 1141, 175 L. Ed. 2d 972 (2010); *Contemporary Industries Corp. v. Frost*, 564 F.3d 981, 51 Bankr. Ct. Dec. (CRR) 157, Bankr. L. Rep. (CCH) P 81473 (8th Cir. 2009).

548.[59] These provisions have been the subject of recent cases that will be discussed in greater detail in section III of this Article.[60]

B. History and Construction of Section 550

In enacting the Bankruptcy Code, Congress took steps to eliminate prior confusion regarding avoidance recoveries under the Bankruptcy Act. Prior to the Bankruptcy Code:

> each avoidance section included its own recovery scheme. *See, e.g.*, 11 U.S.C. § 67 *et seq*. (repealed). However, when [sic] the enactment of the current Bankruptcy Code which repealed the previous Bankruptcy Act, [s]ections 544, 545, 547, 548, and 549 govern avoidance while [s]ection 550 alone governs whether, and to what extent, such avoided transfers may be recovered. According to a House of Representatives Report, "[s]ection 550 . . . enunciates the separation between the concepts of avoiding a transfer and recovering from a transferee."[61]

As one court stated, "[b]y passing section 550, Congress hoped to preclude multiple transfers or convoluted business transactions from frustrating the recovery of avoidable transfers. Such recovery problems existed under the former Bankruptcy Act of

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[59] 11 U.S.C.A. §§ 1521 and 1523 (2009) (each addressing a foreign representative's right to utilize sections 548 and 550 upon recognition of a foreign proceeding). Section 1521(a)(7) appears to allow a court to grant a foreign representative independent avoidance powers in the action pending under Chapter 15, while section 1523(a) appears to permit the foreign representative to exercise those same powers should a case concerning the debtor exist under another Chapter of the Bankruptcy Code. *See* note 254 for the language of sections 1521(a)(7) and 1523(a).

[60] *See In re Condor Ins. Ltd.*, 601 F.3d 319, 328–29, Bankr. L. Rep. (CCH) P 81712 (5th Cir. 2010) (allowing a foreign representative to use foreign avoidance law even though no Chapter 7 or Chapter 11 case is filed in the United States). *In re Condor Insurance Ltd.* is discussed in greater detail in section III.D. of this Article; *see also In re Atlas Shipping A/S*, 404 B.R. 726, 744, 51 Bankr. Ct. Dec. (CRR) 145, 61 Collier Bankr. Cas. 2d (MB) 1141, 2009 A.M.C. 1150 (Bankr. S.D. N.Y. 2009) (a non-fraudulent transfer case stating in *dicta* that it is unclear whether Chapter 15 "precludes a foreign representative from bringing an avoidance action under foreign law").

[61] *In re Coleman*, 299 B.R. 780, 788–89, 92 A.F.T.R.2d 2003-7145 (W.D. Va. 2003), aff'd in part, rev'd in part and remanded on other grounds, 426 F.3d 719, 45 Bankr. Ct. Dec. (CRR) 144, 54 Collier Bankr. Cas. 2d (MB) 1625, Bankr. L. Rep. (CCH) P 80377, 96 A.F.T.R.2d 2005-6641 (4th Cir. 2005); *see also In re Burns*, 322 F.3d 421, 427, 40 Bankr. Ct. Dec. (CRR) 282, 49 Collier Bankr. Cas. 2d (MB) 856, Bankr. L. Rep. (CCH) P 78813, 2003 FED App. 0071P (6th Cir. 2003) ("[A]voidance and recovery are distinct concepts and processes. This is clear from both the statute itself and from its legislative history. Avoidance and recovery are addressed in two separate sections of the code . . ."). For an instructive case on avoidance versus recovery, *see In re Connolly North America, LLC*, 340 B.R. 829, 46 Bankr. Ct. Dec. (CRR) 97 (Bankr. E.D. Mich. 2006).

1898."[62] As noted below with respect to *Deprizio*,[63] these recovery problems have persisted and have been the subject of attempts to refine the language of section 550 to address them. Further, section 550 has been the subject of a number of other challenges. It has survived challenges based on the "presumption against extraterritoriality"[64] and also has survived at least one sovereign immunity challenge in which the United States Supreme Court held that Congress had the "power to authorize courts to avoid preferential transfers and to recover the transferred property" via an action under section 550 and that this authority "operates free and clear of [a state's] claim of sovereign immunity."[65]

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[62]*In re Fabric Buys of Jericho, Inc.*, 33 B.R. 334, 336–37, 11 Bankr. Ct. Dec. (CRR) 109 (Bankr. S.D. N.Y. 1983) (citing 4 Collier on Bankruptcy ¶ 67.41[8] (14th ed. 1982)) (addressing problems regarding transfers among family-owned operations or corporations with single shareholders).

[63]*Levit v. Ingersoll Rand Financial Corp.*, 874 F.2d 1186, 19 Bankr. Ct. Dec. (CRR) 574, 22 Collier Bankr. Cas. 2d (MB) 36, 11 Employee Benefits Cas. (BNA) 1323, Bankr. L. Rep. (CCH) P 72910 (7th Cir. 1989) .

[64]*In re French*, 440 F.3d 145, 151, 46 Bankr. Ct. Dec. (CRR) 1, 55 Collier Bankr. Cas. 2d (MB) 806 (4th Cir. 2006) ("all of a debtor's property, whether domestic or foreign, is 'property of the estate' subject to the bankruptcy court's *in rem* jurisdiction") (relying on *In re Simon*, 153 F.3d 991, 996, 33 Bankr. Ct. Dec. (CRR) 141, Bankr. L. Rep. (CCH) P 77783 (9th Cir. 1998)). In *French*, the Fourth Circuit distinguished the presumption against extraterritoriality rule set forth in *E.E.O.C. v. Arabian American Oil Co.*, 499 U.S. 244, 248, 111 S. Ct. 1227, 113 L. Ed. 2d 274, 55 Fair Empl. Prac. Cas. (BNA) 449, 55 Empl. Prac. Dec. (CCH) P 40607 (1991) by the application of *Kollias v. D & G Marine Maintenance*, 29 F.3d 67, 72, 1995 A.M.C. 609 (2d Cir. 1994) (courts only apply a presumption against extraterritoriality when a party seeks to enforce a statute "beyond the territorial boundaries of the United States") and *Environmental Defense Fund, Inc. v. Massey*, 986 F.2d 528, 531, 36 Env't. Rep. Cas. (BNA) 1053, 23 Envtl. L. Rep. 20601 (D.C. Cir. 1993) (presumption has no bearing when "the conduct which Congress seeks to regulate occurs largely within the United States"). *But see In re Bankruptcy Estate of Midland Euro Exchange Inc.*, 347 B.R. 708, 718–19, 47 Bankr. Ct. Dec. (CRR) 32, 56 Collier Bankr. Cas. 2d (MB) 1041 (Bankr. C.D. Cal. 2006) (finding "no evidence of congressional intent to extend the application of § 548 extraterritorially . . ." and expressly disagreeing with *In re French*).

[65]*Central Virginia Community College v. Katz*, 546 U.S. 356, 369–70, 126 S. Ct. 990, 163 L. Ed. 2d 945, 45 Bankr. Ct. Dec. (CRR) 254, 54 Collier Bankr. Cas. 2d (MB) 1233, Bankr. L. Rep. (CCH) P 80443 (2006) (Holding that "[b]ankruptcy jurisdiction is principally *in rem* jurisdiction . . . As such, its exercise does not, in the usual case, interfere with state sovereignty even when State's interests are affected."). Although the Supreme Court in *Katz* declined to decide "whether actions to recover preferential transfers pursuant to [section 550] are themselves properly characterized as *in rem*," the Supreme Court noted that "[w]hatever the appropriate appellation, those who crafted the Bankruptcy Clause would have understood it to give Congress the power to authorize courts

Section 550 consists of six major subsections. Section 550(a) sets forth the trustee's (or debtor-in-possession's) general recovery powers as follows:[66]

> (a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from:
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> (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
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> (2) any immediate or mediate transferee of such initial transferee.[67]

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to avoid preferential transfers and to recover the transferred property" from states. Katz, 546 U.S. at 372. The Supreme Court also noted that it was not bound by "statements in both the majority and the dissenting opinions" in *Seminole Tribe of Florida v. Florida*, 517 U.S. 44, 55, 116 S. Ct. 1114, 134 L. Ed. 2d 252, 34 Collier Bankr. Cas. 2d (MB) 1199, 42 Env't. Rep. Cas. (BNA) 1289, 67 Empl. Prac. Dec. (CCH) P 43952 (1996) (holding that the States' sovereign immunity can only be abrogated by an express statement by Congress made pursuant to a valid grant of congressional power) as the issue in *Katz* was not one of abrogation. Katz, 546 U.S. at 363. *But see Official Comm. Unsecured Creditors of 360networks In re 360networks (USA), Inc.*, 316 B.R. 797, 43 Bankr. Ct. Dec. (CRR) 275, 53 Collier Bankr. Cas. 2d (MB) 339 (Bankr. S.D. N.Y. 2004), , *vacated per settlement agreement,* 2005 WL 3957809, at *1 (Bankr. S.D.N.Y. Sept. 21, 2005). In *360networks*, the Bankruptcy Court for the Southern District of New York sought to reconcile *Seminole Tribe* with *Tennessee Student Assistance Corp. v. Hood*, 541 U.S. 440, 124 S. Ct. 1905, 1914, 158 L. Ed. 2d 764, 43 Bankr. Ct. Dec. (CRR) 1, 51 Collier Bankr. Cas. 2d (MB) 627, Bankr. L. Rep. (CCH) P 80098 (2004) (finding that a bankruptcy court's exclusive *in rem* jurisdiction over property of the debtor "allows it to adjudicate the debtor's . . . claim without *in personam* jurisdiction over the State"). The bankruptcy court's holding was subsequently vacated by an order filed pursuant to a settlement agreement between the parties. The parties specifically cited the then-upcoming Supreme Court decision in *Katz* as a reason to grant vacature.

[66]Because of the renumbering of section 550 that took place with the incorporation of the 1994 Reform Act, care should be taken when researching prior cases. For example, present section 550(d) was section 550(c) prior to the revisions.

[67]The Court of Appeals for the Eleventh Circuit has held that a trustee can recover from subsequent transferees without first avoiding an initial transfer, so long as the trustee demonstrates that the initial transfer is avoidable; stating that "once the plaintiff proves that an avoidable transfer exists he can then skip over the initial transferee and recover from those next in line." *In re International Administrative Services, Inc.*, 408 F.3d 689, 706, 44 Bankr. Ct. Dec. (CRR) 178, Bankr. L. Rep. (CCH) P 80279 (11th Cir. 2005); *see also In re Richmond Produce Co., Inc.*, 195 B.R. 455, 463, 142 A.L.R. Fed. 715 (N.D. Cal. 1996) ("[O]nce the trustee proves that a transfer is avoidable under section 548, he may seek to recover against any transferee, initial or immediate, or an entity

While recovery of the property transferred is somewhat straightforward, what constitutes value for the purposes of section 550 is not as clear, although at least one court has pondered the subjective value of property in this context.[68]

Initially, section 550(a)(1) did not grant the ability to recover from the "entity for whose benefit such transfer was made." That language was added as a part of the 1984 Bankruptcy Amendments. In adding this provision, Congress specifically noted two limitations: (i) that no duplicate recoveries should be

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for whose benefit the transfer is made."); *In re AVI, Inc.*, 389 B.R. 721, 734–35, 50 Bankr. Ct. Dec. (CRR) 39, 59 Collier Bankr. Cas. 2d (MB) 1753 (B.A.P. 9th Cir. 2008) (relying on *In re Int'l Admin. Servs., Inc.* for the same proposition). *But see In re Slack-Horner Foundries Co.*, 971 F.2d 577, 580, Bankr. L. Rep. (CCH) P 74745 (10th Cir. 1992) ("[I]n order to recover from a subsequent transferee the trustee must first have the transfer of the debtor's interest to the initial transferee avoided under § 548."); *In re Brooke Corp.*, 443 B.R. 847, 852–855 (Bankr. D. Kan. 2010) (following the Tenth Circuit's decision in *Slack-Horner* but noting that *Slack-Horner* is the minority position and may be wrongly decided); *In re Allou Distributors, Inc.*, 379 B.R. 5, 19, 49 Bankr. Ct. Dec. (CRR) 29 (Bankr. E.D. N.Y. 2007) ("before the trustee may obtain an 'actual recovery' from the [m]ovants under § 550(a), he must first avoid the underlying initial transfers."); *In re Furs by Albert & Marc Kaufman, Inc.*, 2006 WL 3735621, *8 (Bankr. S.D. N.Y. 2006) (essential element of a trustee's recovery under § 550(a) was avoidance of the initial transfer); *In re Resource, Recycling & Remediation, Inc.*, 314 B.R. 62, 69, 43 Bankr. Ct. Dec. (CRR) 164, 52 Collier Bankr. Cas. 2d (MB) 1636 (Bankr. W.D. Pa. 2004) ("Section 550(a) is a recovery provision and gives rise to a secondary cause of action which applies after the trustee has prevailed under one (or more) of the avoidance provisions found in the Bankruptcy Code."); *In re Morgan*, 276 B.R. 785, 789 (Bankr. N.D. Ohio 2001) (the statutory language of section 550 and its legislative history leads to the conclusion that a trustee must first avoid an underlying transfer before recovery).

[68] *Active Wear, Inc. v. Parkdale Mills, Inc.*, 331 B.R. 669 (W.D. Va. 2005). In *Active Wear*, a creditor reclaimed from the debtor certain quantities of yarn prior to the petition date. The debtor argued that it should be allowed to recover the value the creditor could realize by reselling the yarn. The creditor argued that the value was such as could have been realized by the debtor in a liquidation sale. The essence of these arguments is that value is subjective—that the same property held by different parties takes on different values in reflection of the party by whom it is held. If so, the net result to the estate would differ depending on the remedy elected. The court concluded that the recoveries under section 550 are simply different sides of the same coin; that the recovery of value under section 550 by a debtor is simply a procedural device that permits the debtor to avoid further disposition of property, but not one that permits a debtor to benefit from an increase in value of property held by a nondebtor. The value recovered would be that which the debtor would obtain should it sell the property. Active Wear, Inc., 331 B.R. at 674.

permitted,[69] and (ii) that the recovery is only permissible to the extent of actual avoidance.[70]

The Bankruptcy Code does not define initial, immediate or mediate transferees nor does it define the type of benefit necessary to make an entity a transferee. In this vein, courts have looked at the recipient's "dominion" over the transferred property,[71] whether the recipient was a "mere conduit,"[72] or whether a

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[69]*See* 11 U.S.C.A. § 550(d).

[70]11 U.S.C.A. § 550(a). *See* 124 Cong. Rec. 32,400 (1978); *see also In re Kingsley*, 518 F.3d 874, 878, 49 Bankr. Ct. Dec. (CRR) 167, Bankr. L. Rep. (CCH) P 81115 (11th Cir. 2008) (bankruptcy court may grant a credit for any repayments made to reduce liability following an avoidable fraudulent transfer under section 548).

[71]*See Paloian v. LaSalle Bank, N.A.*, 619 F.3d 688, 691–92, Bankr. L. Rep. (CCH) P 81840 (7th Cir. 2010) ("*Paloian*") (trustee for securitized investment pool was "initial transferee" of payments on securitized debt as the legal owner of the trust's assets) (*Paloian* is discussed in length in section III.E. of this Article); *In re Antex, Inc.*, 397 B.R. 168, 172–73, 50 Bankr. Ct. Dec. (CRR) 266, 61 Collier Bankr. Cas. 2d (MB) 15 (B.A.P. 1st Cir. 2008) (holding "it is widely accepted that a transferee is one who at least has dominion over the money or other asset, the right to put the money to one's own purposes") (quotations omitted); *In re Sunglasses and Then Some, Inc.*, 51 Bankr. Ct. Dec. (CRR) 257, 2009 WL 2058564, *4 (Bankr. D. Mass. 2009) (in interpreting definition of "transferee," the Court determined that defendant principals or debtor corporation did not have "dominion and control" over funds transferred directly from the debtor to defendants' other corporation); *In re CVEO Corp.*, 327 B.R. 210, 217, 45 Bankr. Ct. Dec. (CRR) 30 (Bankr. D. Del. 2005) ("To have dominion and control means to be capable of using the funds for whatever purpose he or she wishes, be it to invest in lottery tickets or uranium stocks.") (quotations omitted); *see also Bonded Financial Services, Inc. v. European American Bank*, 838 F.2d 890, 893, 17 Bankr. Ct. Dec. (CRR) 299, 18 Collier Bankr. Cas. 2d (MB) 155 (7th Cir. 1988) (the "minimum requirement of status as an [initial] transferee is dominion over the money or other asset, the right to put the money to one's own purposes") (quotations omitted).

[72]*In re Warnaco Group, Inc.*, 97 A.F.T.R.2d 2006-958, 2006 WL 278152, *6–7 (S.D. N.Y. 2006) (applying the mere conduit test under which the minimum requirement of status as a "transferee" is dominion over the money or asset and the right to put the money to one's own purposes); *In re Elrod Holdings Corp.*, 394 B.R. 751, 757 n.4, 60 Collier Bankr. Cas. 2d (MB) 1020 (Bankr. D. Del. 2008) (defendant must be a transferee to be liable for fraudulent transfer because there is no accessory liability provision to support liability against corporate insiders with authority to orchestrate, participate in and/or aid and abet in fraudulent transfer); *see also In re Pony Exp. Delivery Services, Inc.*, 440 F.3d 1296, 1300, 1303–4, 46 Bankr. Ct. Dec. (CRR) 24, Bankr. L. Rep. (CCH) P 80465 (11th Cir. 2006) (applying control test to ascertain whether the initial recipient of the funds transferred was the initial transferee and holding that a "mere conduit" of property will not be deemed the "initial transferee" of the property). A recent Eleventh Circuit decision has added that the demonstration

transferee received a benefit from the transfer[73] but no clear-cut test exists and courts continue to struggle with this requirement.[74]

Section 550(b) provides for separate treatment of initial and subsequent transferees:

> (b) The trustee may not recover under [sub]section (a)(2) of this section from:
>
> (1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and avoided; or
>
> (2) any immediate or mediate good faith transferee of such transferee.

If the recipient of a transfer otherwise avoidable under the avoidance provisions is the initial transferee, the Bankruptcy Code imposes strict liability and the trustee may recover the transfer, but if the recipient was not the initial transferee, he or

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of good faith is a requirement under their circuit's "mere conduit" test. *See In re Harwell*, 628 F.3d 1312, 1323, 64 Collier Bankr. Cas. 2d (MB) 1820, Bankr. L. Rep. (CCH) P 81909 (11th Cir. 2010).

[73]*See In re Meredith*, 527 F.3d 372, 375–77, 50 Bankr. Ct. Dec. (CRR) 45, 59 Collier Bankr. Cas. 2d (MB) 1382, Bankr. L. Rep. (CCH) P 81252 (4th Cir. 2008) (CPA transferred accounting practice to his wife for a brief period; she had no control and received no benefit from the practice and, therefore, recovery under section 550(a)(1) could not be had from her for the transfer); *Freeland v. Enodis Corp.*, 540 F.3d 721, 740, 50 Bankr. Ct. Dec. (CRR) 134, 60 Collier Bankr. Cas. 2d (MB) 524, Bankr. L. Rep. (CCH) P 81315 (7th Cir. 2008) ("requiring that the entity actually receive a benefit from the transfer is consistent with the well-established rule that fraudulent transfer recovery is a form of disgorgement, so that no recovery can be had from parties who participated in a fraudulent transfer but did not benefit from it") (quotations omitted).

[74]*See e.g., Paloian*, 619 F.3d at 691–92 (see discussion at section III.E. of this Article); In re Meredith, 527 F.3d at 376–77 (see note 73); *In re Antex, Inc.*, 397 B.R. 168, 173, 50 Bankr. Ct. Dec. (CRR) 266, 61 Collier Bankr. Cas. 2d (MB) 15 (B.A.P. 1st Cir. 2008) (controlling a corporation and causing checks to be issued does not make a principal of a corporation an initial transferee, since after issuance of checks the principal has no legal dominion and control over use of payment); *see also In re Hurtado*, 342 F.3d 528, 532–36, 41 Bankr. Ct. Dec. (CRR) 229, Bankr. L. Rep. (CCH) P 78904, 2003 FED App. 0312P (6th Cir. 2003) (mother-in-law of debtor to whom property was transferred was the initial transferee because, though she followed the debtor's instructions with respect to disposition of the property, she nonetheless was not legally obligated to do so); In re CVEO Corp., 327 B.R. at 217 (see note 71); *In re Cassandra Group*, 312 B.R. 491, 497–98, 43 Bankr. Ct. Dec. (CRR) 116 (Bankr. S.D. N.Y. 2004) (finding that, despite the fact that he paid himself out of collected proceeds, the agent of the landlord did not have sufficient dominion over collected rents to make him an initial transferee).

she may assert a good faith defense.[75] Nonetheless, the legislative history to section 550 makes it clear that the recovery provisions only apply to the extent a transaction is avoidable. Thus, if the underlying avoidance statute contains defenses,[76] those defenses will be effective regardless of the strict liability of initial transferees provided in section 550(b).[77]

Section 550(c) was added by the 1994 Reform Act in response to the *Deprizio* case regarding preferential transfers involving insiders.[78] Section 550(c) states that:

> (c) If a transfer made between 90 days and one year before the filing of the petition:
>
> (1) is avoided under section 547(b) of this title; and
>
> (2) was made for the benefit of a creditor that at the time of such transfer was an insider;
>
> the trustee may not recover under subsection (a) from a transferee that is not an insider.

In *Deprizio*, the Seventh Circuit considered whether and to what extent a transfer for the benefit of an insider of the debtor, but nonetheless to a non-insider, could be recovered as an avoidable preference. The debtor had made a payment to a lender more than 90 days but less than one year prior to bankruptcy, on loans either directly guaranteed by insiders of the debtor or which were secured by collateral in which the insiders had an interest.[79] The lender itself was not considered an insider.[80] The Court held that the trustee could recover the payment from the lender, even

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[75] *In re Red Dot Scenic, Inc.*, 351 F.3d 57, 58 (2d Cir. 2003) ("If the recipient of debtor funds was the initial transferee, the bankruptcy code imposes strict liability and the bankruptcy trustee may recover the funds . . . If the recipient was not the initial transferee, however, he or she may assert a good faith defense."); *In re Resource, Recycling & Remediation, Inc.*, 314 B.R. 62, 70–1, 43 Bankr. Ct. Dec. (CRR) 164, 52 Collier Bankr. Cas. 2d (MB) 1636 (Bankr. W.D. Pa. 2004) (employee who took property transferred by debtor to a shell corporation and subsequently abandoned to the employee in return for disposing of barrels of ink, took "for value" under section 550(b)).

[76] *See, e.g.*, 11 U.S.C.A. §§ 548(c) and 546(e).

[77] *In re H. King & Associates*, 295 B.R. 246, 285–86 (Bankr. N.D. Ill. 2003) (holding that section 548(c), not section 550(b), is the appropriate and sole good faith defense for initial transferees of allegedly fraudulent conveyances).

[78] *Levit v. Ingersoll Rand Financial Corp.*, 874 F.2d 1186, 19 Bankr. Ct. Dec. (CRR) 574, 22 Collier Bankr. Cas. 2d (MB) 36, 11 Employee Benefits Cas. (BNA) 1323, Bankr. L. Rep. (CCH) P 72910 (7th Cir. 1989) .

[79] Levit, 874 F.2d at 1187–88.

[80] Levit, 874 F.2d at 1198.

though the lender was not an insider, because the transfer benefited the insider.[81] The *Deprizio* court further held that, pursuant to section 550(a), the trustee could recover either the transferred property or its value from either the lender as initial transferee or the guarantor, the insider "for whose benefit such transfer was made."

Section 550(c) was intended to solve the *Deprizio* problem. It makes clear that recovery of an avoidable transfer to an insider cannot be obtained from an initial transferee where the initial transferee was not an insider, regardless of whether the transfer ultimately benefited an insider.[82]

While the addition of the language "or the entity for whose benefit such transfer was made" to section 550(a)(1) in the 1984 Amendments[83] was intended to clarify that recovery can be sought from an insider under such circumstances even though such insider is not a transferee for the purposes of section 550(a) of the Bankruptcy Code, section 550(c) now makes it clear that recovery cannot be sought from the non-insider initial transferee under such facts.[84] However, this clarification is still subject to much debate, largely because Congress continued to mistake the distinction between avoidance and recovery.[85]

Section 550(d) states that "[t]he trustee is entitled to only a

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[81]Levit, 874 F.2d at 1200–1.

[82]*See In re Exide Technologies, Inc.*, 299 B.R. 732, 746 (Bankr. D. Del. 2003) (holding that it is consistent with the legislative intent behind section 550(c) to prohibit a trustee from recovering from a noninsider transferee); *In re Mid-South Auto Brokers, Inc.*, 290 B.R. 658, 662, 41 Bankr. Ct. Dec. (CRR) 22, 49 Collier Bankr. Cas. 2d (MB) 1544 (Bankr. E.D. Ark. 2003) (same).

[83]*See* House Report No. 103-835; 1994 U.S.C.C.A.N. 3340.

[84]*See* In re Exide Techs., Inc., 299 B.R. at 746; In re Mid-South Auto Brokers, Inc., 290 B.R. at 662.

[85]Though intertwined, avoidance and recovery are two independent remedies. Even absent recovery, other benefits may inure simply from avoidance depending on the nature of the transfer avoided. *In re Burns*, 322 F.3d 421, 427, 40 Bankr. Ct. Dec. (CRR) 282, 49 Collier Bankr. Cas. 2d (MB) 856, Bankr. L. Rep. (CCH) P 78813, 2003 FED App. 0071P (6th Cir. 2003) (holding that avoidance legally negates the transfer and, as the property was still in possession of the debtor, there was no need to invoke section 550 for recovery); *In re Morgan*, 276 B.R. 785, 792 (Bankr. N.D. Ohio 2001) (when a nonpossessory interest in property is avoided, there is nothing left to recover). The quintessential case is where the transfer is a lien placed by a non-insider on property of the debtor's estate, securing an obligation of an insider. By avoiding the lien, the property is "free and clear" of that interest even though no recovery from the non-insider lender is possible. *See In re Rosen Auto Leasing, Inc.*, 346 B.R. 798, 805–6, 46 Bankr. Ct. Dec. (CRR) 235 (B.A.P. 8th Cir. 2006) (lien on debtor's condominium extinguished when not exchanged for value and labeled a fraudulent transfer to

single satisfaction under subsection (a) of this section" and has generated little but confirming case law.[86]

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non-insider lender); *In re Williams*, 234 B.R. 801, 803–5, 34 Bankr. Ct. Dec. (CRR) 600 (Bankr. D. Or. 1999). The avoidance/recovery distinction was featured in several prominent cases in 2005. *See In re Coleman*, 426 F.3d 719, 726, 45 Bankr. Ct. Dec. (CRR) 144, 54 Collier Bankr. Cas. 2d (MB) 1625, Bankr. L. Rep. (CCH) P 80377, 96 A.F.T.R.2d 2005-6641 (4th Cir. 2005) (holding that "the concepts are intertwined to the extent that property cannot be recovered under § 550 until an action is brought to avoid the transfer of that property . . . But the opposite is certainly not true . . ." when debtor avoided deeds of trust and no recovery was necessary as the "avoidance itself was the meaningful event"); *In re International Administrative Services, Inc.*, 408 F.3d 689, 703, 44 Bankr. Ct. Dec. (CRR) 178, Bankr. L. Rep. (CCH) P 80279 (11th Cir. 2005) (noting that the "demarcation between avoidance and recovery is underscored by § 550(f), which places a separate statute of limitations on recovery actions").

In BAPCPA, Congress again attempted a fix, this time in section 547(i), which reads:

> If the trustee avoids under subsection (b) a transfer made between 90 days and 1 year before the date of the filing of the petition, by the debtor to an entity that is not an insider for the benefit of a creditor that is an insider, such transfer shall be considered to be avoided under this section only with respect to the creditor that is an insider.

11 U.S.C.A. § 547(i). Two potential problems with the new fix exist. The first is that section 547(i) is limited on its face to transfers benefiting insiders who are creditors. While unlikely, it is possible that an insider benefiting from such transfer may not also be a creditor. At least on its face, strict avoidance as opposed to recovery would not give rise to creditor status under sections 502(h) and 101(10)(B) unless recovery—as opposed to avoidance—was sought against the insider/creditor, *compare* 11 U.S.C.A. § 101(10) (defining "creditor") *with* 11 U.S.C.A. § 101(31) (defining "insider"), in which case it appears that the problem of avoidance without transfer for the non-insider initial transferee may still exist. When an estate is faced with a *Deprizio* transfer and a judgment-proof insider, the result is a "catch-22."

[86] *See In re Skywalkers, Inc.*, 49 F.3d 546, 549, 26 Bankr. Ct. Dec. (CRR) 1006, Bankr. L. Rep. (CCH) P 76394 (9th Cir. 1995) (duplicative recoveries inappropriate); *In re Friedman's Inc.*, 394 B.R. 623, 628–629 (S.D. Ga. 2008) (same); *In re G-I Holdings, Inc.*, 2006 WL 1751793, *15 (D.N.J. 2006) (same); *In re Bean*, 251 B.R. 196, 205 (E.D. N.Y. 2000), aff'd, 252 F.3d 113, 37 Bankr. Ct. Dec. (CRR) 268, Bankr. L. Rep. (CCH) P 78465 (2d Cir. 2001) (same); *In re Bassett*, 221 B.R. 49, 55, 32 Bankr. Ct. Dec. (CRR) 820 (Bankr. D. Conn. 1998) (same); *In re Armstrong*, 217 B.R. 569, 579 (Bankr. E.D. Ark. 1998) (same); *In re Bennett*, 133 B.R. 374, 381–82 (Bankr. N.D. Tex. 1991) (same); *In re Jameson's Foods, Inc.*, 35 B.R. 433, 440, 37 U.C.C. Rep. Serv. 1381 (Bankr. D. S.C. 1983) (same); *see also In re Sawran*, 359 B.R. 348 (Bankr. S.D. Fla. 2007) (trustee denied recovery where debtor transferred $20,000 to her father, who transferred it to third parties, who paid the debtor $12,000 prior to the bankruptcy because permitting recovery would result in a windfall to the estate); *In re Ames Dept. Stores, Inc.*, 161 B.R. 87, 91 (Bankr. S.D. N.Y. 1993) (debtor reimbursed for transfer, thus no diminishment in estate and no recovery permitted). At least one court has held that damages are an appropriate remedy for fraudulent

One court has creatively used section 550(d) to prohibit a trustee from recovering from a bank that, without notice of the bankruptcy case, continued to sweep the debtor's bank accounts and make advances to the debtor post-petition.[87] The district court found that while the strict requirements for recovery under section 550 had been met, the post-petition advances more than offset the sweeps, and therefore ruled that the trustee's attempt to recover was duplicative with the advances and prohibited under section 550(d).[88]

Section 550(e) provides remedies for good faith transferees from whom a transfer is avoided, namely a lien in the property recovered, to the extent of the lesser of the cost of any improvement the transferee makes in the transferred property and the increase in value of the property as a result of the improvement, as follows:

(e)(1) A good faith transferee from whom the trustee may recover under subsection (a) of this section has a lien on the property recovered to secure the lesser of:

(A) the cost, to such transferee, of any improvement made after the transfer, less the amount of any profit realized by or accruing to such transferee from such property; and

(B) any increase in the value of such property as a result of such improvement, of the property transferred.

(2) In this subsection, "improvement" includes:

(A) physical additions or changes to the property transferred;

(B) repairs to such property;

(C) payment of any tax on such property;

(D) payment of any debt secured by a lien on such property that is superior or equal to the rights of the trustee; and

(E) preservation of such property.

The statute clearly states that this section only protects good faith "initial" transferees. As noted above, only initial transferees are strictly liable due to the operation of section 550(b) and therefore good faith subsequent transferees will not need this section as they will not have their transfers avoided. Moreover,

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transfer under federal law. *See In re IVDS Interactive Acquisition Partners*, 302 Fed. Appx. 574, 576–77 (9th Cir. 2008) (holding that partnership's founders were jointly and severally liable on a recovery action for funds fraudulently transferred from the partnership).

[87]*In re Cybridge Corp.*, 312 B.R. 262, 43 Bankr. Ct. Dec. (CRR) 81, 52 Collier Bankr. Cas. 2d (MB) 615 (D.N.J. 2004).

[88]*In re Cybridge Corp.*, 312 B.R. 262, 43 Bankr. Ct. Dec. (CRR) 81, 52 Collier Bankr. Cas. 2d (MB) 615 (D.N.J. 2004).

where a transfer is avoided under section 548 but not recovered under section 550, the protections set forth in section 550(e) do not apply.[89]

Finally, section 550(f) provides a statute of limitations for recovery actions by stating that "[a]n action or proceeding under [section 550] may not be commenced after the earlier of (1) one year after the avoidance of the transfer on account of which recovery under this section is sought; or (2) the time the case is closed or dismissed."[90] Section 550(f) is jurisdictional in nature, and is not waived by the defendant's failure to timely plead.[91] Note that the time frame runs from the date the transfer was avoided, not the date of the transfer.[92]

III. Case Law Developments in 2010

This section summarizes and analyzes certain decisions issued in 2010 discussing sections 548 and/or 550 that the author believes to be of import and general interest to bankruptcy practitioners. This is not a complete analysis of the issues discussed or the case law regarding the same, but rather is intended to provide the reader with a selected sampling of interesting issues bankruptcy and appellate courts have considered during the past year.

A. Ponzi Schemes: *Bayou IV and Picard v. Merkin*

The exposure of the multibillion-dollar Madoff Ponzi scheme as well as several other recent Ponzi schemes[93] has resulted in an increased focus on the prosecution of avoidance actions in Ponzi

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[89]In re Burns, 322 F.3d at 427 (when debtor transferred title to property to third party but retained possession, the transfer was preserved for the benefit of the estate under section 551, no recovery after avoidance was necessary, and the protections of section 550 do not apply).

[90]*In re Enron Corp.*, 343 B.R. 75, 80, 46 Bankr. Ct. Dec. (CRR) 147, 56 Collier Bankr. Cas. 2d (MB) 195 (Bankr. S.D. N.Y. 2006), rev'd and remanded on other grounds, 388 B.R. 489 (S.D. N.Y. 2008) ("Section 546(a) sets forth the statute of limitations for an avoidance action and section 550(f) sets forth the limitation period for a recovery."); *see also In re Menk*, 241 B.R. 896, 911, 43 Collier Bankr. Cas. 2d (MB) 336 (B.A.P. 9th Cir. 1999) (closing of a bankruptcy case terminates many of the trustee's avoiding and recovery powers).

[91]*In re Phimmasone*, 249 B.R. 681, 683, 44 Collier Bankr. Cas. 2d (MB) 890 (Bankr. W.D. Va. 2000).

[92]In re Enron Corp., 343 B.R. at 80 (the limitations period starts to run once the trustee avoids the transfer sought to be recovered); *In re Serrato*, 233 B.R. 833, 835, 41 Collier Bankr. Cas. 2d (MB) 1461 (Bankr. N.D. Cal. 1999).

[93]Other recently exposed Ponzi schemes include those perpetrated by: Scott Rothstein (*see* Ashby Jones, *Rothstein Draws 50-Year Sentence: Former Florida Lawyer Was Convicted of Running a $1.2 Billion Ponzi Scheme*, The Wall Street

scheme bankruptcy and liquidation cases. Ponzi scheme cases are unique in that there is often little or no real business to reorganize. Rather, these cases are about unraveling the scheme and recovering assets for redistribution to creditors and investors. Recent litigation reveals the tension between criminal prosecutors, trustees, creditors, innocent investors and investors who arguably knew or should have known of the scheme. Courts grapple with issues of "fictitious" profits, and clashes between "net-winners" and "net-losers" of schemes, *i.e.*, those parties who received Ponzi scheme payments exceeding their principal investment versus those parties who either never redeemed or were paid less than the amounts they invested. Thus, courts have been required to examine the unique issues surrounding avoidance and recovery of fraudulent transfers in the Ponzi scheme context. Among the developments of 2010 in this area of law are the decisions recently issued by the District Court for the Southern District of New York in *Bayou IV*[94] and by the Bankruptcy Court for the Southern District of New York in *Picard v. Merkin*.[95]

1. *Bayou IV*

The standards for evaluating the "good faith" defense of section 548(c) raised by investor-defendants who received redemption payments prior to the collapse of a Ponzi scheme were the primary focus of the Southern District of New York's decision in *Bayou IV*. In *Bayou IV,* the district court reversed the bank-

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Journal (June 10, 2010), http://online.wsj.com/article/SB10001424052748704575304575296662423872880.html?dbk); Marc Drier (*see* Benjamin Weiser, *Lawyer Pleads Guilty in $400 Million Fraud*, The New York Times (May 11, 2009), http://www.nytimes.com/2009/05/12/nyregion/12dreier.html); Tom Petters (*see 50-Year Term for Minnesota Man in $3.7 Billion Ponzi Fraud*, The New York Times (April 8, 2009), http://www.nytimes.com/2010/04/09/business/09ponzi.html); and Allen Stanford (*see Press Release: SEC Charges R. Allen Stanford, Stanford International Bank for Multi-Billion Dollar Investment Scheme* (Feb. 17, 2009), http://www.sec.gov/news/press/2009/2009-26.htm).

[94] *In re Bayou Group, LLC*, 439 B.R. 284 (S.D. N.Y. 2010). The Bayou Group bankruptcy has resulted in a line of cases focused on whether or not the prepetition redemption payments made to investors were fraudulent transfers. *See In re Bayou Group, LLC*, 362 B.R. 624, 47 Bankr. Ct. Dec. (CRR) 262 (Bankr. S.D. N.Y. 2007) (denying investors' motion to dismiss the debtor's fraudulent transfer actions) ("*Bayou I*"); *see also In re Bayou Group, LLC*, 372 B.R. 661, 48 Bankr. Ct. Dec. (CRR) 170 (Bankr. S.D. N.Y. 2007) (court denied defendants' summary judgment motion) ("*Bayou II*").

[95] *In re Bernard L. Madoff Inv. Securities, LLC*, 440 B.R. 243, 64 Collier Bankr. Cas. 2d (MB) 957 (Bankr. S.D. N.Y. 2010) (*"Picard v. Merkin"*).

ruptcy court's controversial decision[96] that narrowed the applicability of the "good faith" defense of section 548(c) of the Bankruptcy Code and clarified the standards for applying that defense to actions seeking to avoid as actually fraudulent transfers redemption payments made to investors. In addition, *Bayou IV* reversed the bankruptcy court's related ruling regarding the extent to which a "diligent investigation" is required when an investor has become aware of certain "red flags." Finally, the district court upheld the bankruptcy court's ruling regarding the avoidance of fictitious profits as constructively fraudulent transfers.

The Bayou Group consisted of a number of hedge funds and a broker-dealer (collectively "Bayou") and attracted investments of approximately $450 million prior to its collapse in 2005.[97] Almost from its inception in 1996, Bayou was operated as a Ponzi scheme.[98] It attracted new investors by distributing impressive returns supported by fraudulent performance summaries authored by a fictitious accounting firm.[99] As with most Ponzi schemes, investors' redemption payments were not supported by trading or investment profits, but instead were funded by new investors' cash infusions.[100] These redemption payments (made up of both fictitious profits and principal) were at the heart of the

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[96]The bankruptcy court granted summary judgment against investors who, by virtue of certain "red flags," were found to have been on inquiry notice and were therefore required to conduct an investigation in order to satisfy the good faith defense under section 548. *In re Bayou Group, LLC*, 396 B.R. 810, 845–49 (Bankr. S.D. N.Y. 2008), ("*Bayou III*").

[97]Bayou Group, LLC, 396 B.R. at 822 & 829.

[98]Bayou Group, LLC, 396 B.R. at 822. A Ponzi scheme is an investment scheme that is not supported by a legitimate underlying business venture. Early investors are paid profits from the sums paid in by newly attracted investors. Usually those who invest in the scheme are promised large returns on their principal investments. Initial investors are often paid the sizable promised returns. This attracts additional investors. More and more investors need to be attracted into the scheme so that the growing number of investors on top can get paid. The Ponzi scheme acquired its name from Charles K. Ponzi (1882–1949) who during an eight-month period in 1920 swindled American investors for an amount in excess of $15 Million. *Balaber-Strauss v. Lawrence*, 264 B.R. 303, 305–6, 46 Collier Bankr. Cas. 2d (MB) 851 (S.D. N.Y. 2001).

[99]Bayou III, 396 B.R. at 822–23.

[100]Bayou IV, 439 B.R. at 306–7 (noting that the bankruptcy court found all of the essential elements of a Ponzi scheme).

Bayou IV decision rendered by the Southern District of New York in September 2010.[101]

In *Bayou III,* the bankruptcy court granted the debtors' motions for summary judgment on certain claims seeking to avoid and recover, as fraudulent transfers, redemption payments made to investors. The bankruptcy court denied the investors' cross-motions for summary judgment based upon their assertion of a good faith defense pursuant to section 548(c) of the Bankruptcy Code. Departing from earlier precedent, the bankruptcy court narrowed the standards for applying the good faith defense, and held that the redeeming investors could not rely upon the "good faith" defense of section 548(c) if there was evidence that they redeemed their investments after learning of certain "red flags" that put them "on notice of *some potential infirmity* in the investment such that a reasonable investor would recognize the need to conduct some investigation," and they subsequently failed to conduct such an investigation.[102]

Several investor-defendants challenged the bankruptcy court's rulings related to, *inter alia*, the standard applicable to the good faith defense.[103] In reviewing the bankruptcy court's decision, the district court addressed four major issues: (1) whether fraudulent transfer laws applied to the redemption payments, taking into consideration the defendants' argument that the redemption payments were in satisfaction of an underlying debt; (2) the applicability of the Ponzi scheme presumption and whether actual fraudulent transfers had been alleged; (3) whether the bankruptcy court misapplied the law by broadening the test for inquiry notice and determining that the investors had not established a good faith defense for purposes of section 548(c); and (4) whether payments of fictitious profits were recoverable as constructively fraudulent transfers.

a. Redemption Payments Not in Satisfaction of Antecedent Debt

The district court rejected the investors' contention that fraudulent transfer laws were not applicable to the redemption payments because the payments were made in satisfaction of an antecedent debt. In so doing, the court determined that the

[101]Specifically, the redemption payments made within two years of Bayou's collapse in 2005 were challenged. Bayou IV, 439 B.R. at 293–94.

[102]Bayou III, 396 B.R. at 848 (emphasis added).

[103]Bayou IV, 493 B.R. at 295–96.

investors' reliance on *In re Sharp International Corporation*[104] was misplaced and found that the holding of *Sharp* provided no basis for dismissing the debtors' actual fraudulent transfer claim seeking avoidance of the redemption payments.[105] In *Sharp*, the payment that the debtor sought to avoid was a disclosed and lawful payment on account of a valid contractual antecedent debt to a lender that was not incurred as a result of a fraudulent transfer.[106] The redemption payments made to the Bayou investors were unlike the repayment of the debt at issue in *Sharp* because the Bayou redemption payments were made primarily to "avoid detection of the fraud, to retain existing investors, and to lure in new investors."[107] Bayou's redemption payments were inherently fraudulent and constituted "an integral and essential element of the alleged fraud, necessary to validate the false financials and to avoid disclosure."[108]

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[104]*In re Sharp Intern. Corp.*, 403 F.3d 43, 44 Bankr. Ct. Dec. (CRR) 146 (2d Cir. 2005). In *Sharp*, the debtor brought intentional and constructive fraudulent conveyance claims against its lender, State Street Bank, under New York Debtor Creditor Law (NYDCL) §§ 272 to 276. Sharp's controlling shareholders had used fraudulent records to obtain loans from numerous banks, including State Street. Once State Street suspected that Sharp was operating fraudulently, it demanded that Sharp obtain new financing to pay off the amount of indebtedness under the State Street line of credit. The Second Circuit in *Sharp* affirmed the dismissal of an actual fraudulent transfer complaint because it inadequately alleged the fraud with respect to the transfer Sharp sought to avoid. Bayou IV, 439 B.R. at 301 (quoting Sharp, 403 F.3d at 56). The *Bayou IV* decision provides a detailed summary of the issues involved in *Sharp*. Bayou IV, 439 B.R. at 300–4.

[105]Bayou IV, 439 B.R. at 304.

[106]Bayou IV, 439 B.R. at 302 n.16.

[107]Bayou IV, 439 B.R. at 302 (quoting *In re Bayou Group, LLC*, 372 B.R. 661, 663, 48 Bankr. Ct. Dec. (CRR) 170 (Bankr. S.D. N.Y. 2007)).

[108]Bayou IV, 439 B.R. at 302 (quoting Bayou III, 372 B.R at 663). In addition, because *Sharp* was based solely on claims asserted under the NYDCL, the court found that *Sharp* could not serve as a basis for dismissing the debtors' actual fraudulent conveyance claim under section 548(c) of the Bankruptcy Code. Bayou IV, 439 B.R. at 302–3. The district court observed that both the pleading standard and the burden of proof are different under the NYDCL, as "[u]nder New York law, the party seeking to have the transfer set aside has the burden of proof on the element of fair consideration and, since it is essential to a finding of fair consideration, good faith." Bayou IV, 439 B.R. at 302–3 (citing *In re Actrade Financial Technologies Ltd.*, 337 B.R. 791, 802 (Bankr. S.D. N.Y. 2005)). Under section 548(c) of the Bankruptcy Code, however, "good faith" is an affirmative defense that must be proved by the defendant.

b. Actual Fraudulent Transfer and the Ponzi Scheme Presumption

The district court examined whether the debtors presented a *prima facie* case for actual fraudulent transfer. While none of the appellant investors challenged the bankruptcy court's finding that Bayou principals had authorized the redemption payments with actual intent to defraud Bayou's creditors, one investor argued that the bankruptcy court mistakenly applied the "Ponzi scheme presumption,"[109] a presumption that establishes a *prima facie* case of actual fraudulent transfer when transfers are made in the context of an established Ponzi scheme.[110] In agreeing with the bankruptcy court's determination that Bayou acted with actual intent to defraud its creditors, the district court held that the bankruptcy court found all of the essential elements of a Ponzi scheme necessary to apply the presumption to Bayou, including:

> principals who made up numbers to disguise trading losses and self-dealing; . . . reports to investors containing 'falsely inflated earnings' that were designed to 'deceitfully induce present investors to retain their accounts and prospective investors to invest'; redemption payments that correlated with previously issued 'falsely inflated account statements' that bore no relation to the account's

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[109]Bayou IV, 439 B.R. at 306.

[110]Bayou IV, 439 B.R. at 306 n.19 (citing *In re Manhattan Inv. Fund Ltd.*, 397 B.R. 1, 7 (S.D. N.Y. 2007)). *See generally In re AFI Holding, Inc.*, 525 F.3d 700, 704, 49 Bankr. Ct. Dec. (CRR) 243, Bankr. L. Rep. (CCH) P 81218 (9th Cir. 2008) (noting that the existence of a Ponzi scheme is sufficient to establish actual intent to defraud under section 548(a)(1)); *Armstrong v. Collins*, 2010 WL 1141158, *20 (S.D. N.Y. 2010) (Ponzi scheme operators necessarily act with "actual intent to defraud creditors due to the nature of their schemes.") (quoting *Terry v. June*, 432 F. Supp. 2d 635, 639 (W.D. Va. 2006)); *Quilling v. Stark*, 2006 WL 1683442, *6 (N.D. Tex. 2006) (the existence of a Ponzi scheme makes the transfer of funds fraudulent as a matter of law); *In re Rothstein Rosenfeldt Adler, P.A.*, 2010 WL 5173796, *5 (Bankr. S.D. Fla. 2010) ("bankruptcy courts nationwide have recognized that establishing the existence of a Ponzi scheme is sufficient to prove a Debtor's actual intent to defraud") (quoting *In re McCarn's Allstate Finance, Inc.*, 326 B.R. 843, 850, 44 Bankr. Ct. Dec. (CRR) 275 (Bankr. M.D. Fla. 2005)); *In re 1031 Tax Group, LLC*, 439 B.R. 47, 72 (Bankr. S.D. N.Y. 2010), subsequent determination, 439 B.R. 84 (Bankr. S.D. N.Y. 2010) and opinion supplemented, 439 B.R. 78 (Bankr. S.D. N.Y. 2010) (noting that if the Ponzi scheme presumption applies, "actual intent for purposes of section 548(a)(1)(A) is established 'as a matter of law.' ") (quoting In re Manhattan Inv. Fund Ltd., 397 B.R. at 14); *In re Christou*, 2010 WL 4008167, *3 (Bankr. N.D. Ga. 2010) (stating that transfers made during the course of a Ponzi scheme are "presumptively made with intent to defraud"); Picard v. Merkin 440 B.R. at 255 ("It is now well recognized that the existence of a Ponzi scheme establishes that transfers were made with the intent to hinder, delay and defraud creditors.").

true value, and thus involved the use of new investors' money to pay off redeemers.[111]

Further, the district court found that Bayou qualified as a Ponzi scheme under the definition supplied by the Second Circuit in *In re Bennett Funding Group, Inc.*,[112] noting that a Ponzi scheme exists where " 'money contributed by later investors is used to pay artificially high dividends to the original investors, creating an illusion of profitability.' "[113] Because Bayou's operation fit the definition of a Ponzi scheme, the district court applied the Ponzi scheme presumption even though the bankruptcy court had not expressly done so.[114] The district court further observed that even if the Ponzi scheme presumption were not applicable, there was ample evidence to establish that the Bayou principals acted with actual fraudulent intent and none of the evidence offered created a material issue of fact on that point.[115]

c. The Good Faith Defense and "Red Flags"

Undoubtedly the most discussed portion of *Bayou III* was the bankruptcy court's adoption of the "some infirmity" standard for examining the applicability of a good faith defense asserted under section 548(c) of the Bankruptcy Code. The controversy centered around the bankruptcy court's rejection, as a matter of law, of the good faith defenses raised by certain investors. Specifically,

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[111]Bayou IV, 439 B.R. at 307 (citing *Bayou III* at 842–43).

[112]*In re The Bennett Funding Group, Inc.*, 439 F.3d 155, 157 n.2, 46 Bankr. Ct. Dec. (CRR) 12 (2d Cir. 2006). *In re Bennett Funding Grp., Inc.* cites to Black's Law Dictionary for the definition of a Ponzi scheme, stating that a Ponzi scheme is "a fraudulent investment scheme in which money contributed by later investors is used to pay artificially high dividends to the original investors, creating an illusion of profitability, thus attracting new investors." *In re The Bennett Funding Group, Inc.*, 439 F.3d 155, 157 n.2, 46 Bankr. Ct. Dec. (CRR) 12 (2d Cir. 2006)

[113]Bayou IV, 439 B.R. at 307 (quoting In re The Bennett Funding Grp., Inc., 439 F.3d at 157 n.2).

[114]Bayou IV, 439 B.R. at 307. The district court rejected the investors' argument that the Ponzi scheme presumption did not apply in this case because there was no evidence of a promise for extraordinarily high returns. Bayou IV, 439 B.R. at 307 n.21.

[115]Bayou IV, 439 B.R. at 307–8. The court noted that actual fraudulent intent was evidenced by the Bayou principals' guilty pleas and an expert's report (the "Lenhart Report") that established that the Bayou Hedge Funds were insolvent when the redemption payments were made. Bayou IV, 439 B.R. at 307–8 (quotations omitted). Other courts have held that actual intent for the purpose of section 548(a)(1)(A) of the Bankruptcy Code may be imputed from guilty pleas of principal actors. *See, e.g., In re Rothstein Rosenfeldt Adler, P.A.*, 2010 WL 5173796, *5 (Bankr. S.D. Fla. 2010).

the bankruptcy court held that the investors were on inquiry notice of Bayou's fraudulent purpose because they had knowledge of "*some potential infirmity*" in their investment or "*some infirmity* in Bayou or the integrity of its management" based upon certain "red flags,"[116] and that the investors had not performed a diligent investigation.[117] In so doing, the bankruptcy court expanded the scope of what constituted a "red flag" sufficient to place an investor on inquiry notice of the fraud, departed from earlier case law, and abandoned the "reasonable person" benchmark for determining whether a defendant had conducted a diligent investigation for purposes of section 548(c).[118]

The district court reversed the bankruptcy court's "some infirmity" standard and reasoned that whether a "red flag" was sufficient to put an investor on inquiry notice was determined by whether a transferee was "informed by the standards, norms, practices, sophistication, and experience generally possessed by participants in the transferee's industry or class."[119] Ultimately, the district court ruled that the proper standard for evaluating a good faith defense under section 548(c) was "whether the alleged red flags would have put a *reasonably prudent institutional hedge fund investor* on inquiry notice that Bayou was insolvent or that

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[116]The three "red flags" pointed to were (1) allegations made in a lawsuit filed against Bayou by a former principal of Bayou, Paul Westervelt; (2) Bayou's delay in providing net asset values ("NAVs"), inconsistent statements about who was responsible for preparing NAVs, and Bayou's eventual disclosure that an in house entity, Bayou Management, was calculating NAVs for Bayou; and (3) negative information concerning Sam Israel and Bayou set forth in two background investigation reports.

[117]Bayou III, 396 B.R. at 848, 865–78, 880–82 (emphasis added).

[118]For a discussion of the "reasonable person" benchmark, *see generally In re Agricultural Research and Technology Group, Inc.*, 916 F.2d 528, 536, 23 Collier Bankr. Cas. 2d (MB) 1517, Bankr. L. Rep. (CCH) P 73652 (9th Cir. 1990) (noting that courts look to whether a "reasonable person" would have been put on notice of a "debtor's fraudulent purpose"); *In re World Vision Entertainment, Inc.*, 275 B.R. 641, 659 (Bankr. M.D. Fla. 2002) (whether or not a diligent investigation occurred depends on the question of whether the circumstances would place a " 'reasonable person on inquiry of a debtor's fraudulent purpose"') (quoting *In re Agricultural Research and Technology Group, Inc.*, 916 F.2d 528, 536, 23 Collier Bankr. Cas. 2d (MB) 1517, Bankr. L. Rep. (CCH) P 73652 (9th Cir. 1990); *In re Model Imperial, Inc.*, 250 B.R. 776, 798 (Bankr. S.D. Fla. 2000) (question is whether the transferee was aware of any facts that would have caused a "reasonable person to make further inquiry into the possible fraudulent purpose of the transaction").

[119]Bayou IV, 439 B.R. at 313.

it had a fraudulent purpose in making the redemption payments to [investors]."[120]

The district court began its discussion of this issue by observing that neither the Bankruptcy Code nor the legislative history of section 548(c) of the Bankruptcy Code defines "good faith."[121] Additionally, the court noted that there is a "lack of clarity if not outright confusion" as to its definition,[122] and found that the weight of authority examining the "good faith" defense indicated that the court should focus on circumstances specific to the transfer at issue and whether a transferee reasonably should have known of the transferor's possible insolvency or fraudulent intent.[123] If the transferee is found to be on inquiry notice, the next test is whether a diligent inquiry would have uncovered the fraudulent purpose.[124] The court grappled with the "some infirmity" standard articulated by the bankruptcy court, noting that this standard, as related to Bayou's management, could cover a host of sins, unrelated to financial information. The court found that the standard was so broad as to be undefinable, and could include "a poor business model, incompetent management, inadequate accounting controls . . . poor marketing, insufficient capital, and a host of other deficiencies."[125] Accordingly, the district court held that "the [b]ankruptcy [c]ourt committed legal error" in applying a "some infirmity" standard.[126]

In addressing the extent to which an investor must conduct a "diligent investigation," the district court found that applying the bankruptcy court's ruling would require courts to determine the subjective motives and intentions of transferees "in contravention

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[120]Bayou IV, 439 B.R. at 313 (emphasis added).

[121]Bayou IV, 439 B.R. at 309. The text of section 548(c) of the Bankruptcy Code is set forth in note 37 of this Article.

[122]Bayou IV, 439 B.R. at 309 (citing *Jimmy Swaggart Ministries v Hayes* (*In re Hannover Corp.*, 310 F.3d 796, 800, 40 Bankr. Ct. Dec. (CRR) 116, 49 Collier Bankr. Cas. 2d (MB) 1061, Bankr. L. Rep. (CCH) P 78741 (5th Cir. 2002) (noting, that there is little agreement among courts as to what conditions should allow a transferee the good faith defense)); *see also* In re Agric. Research & Tech. Grp., 916 F.2d at 536 (stating that courts have typically acknowledged that good faith is not susceptible to a precise definition); *In re Telesphere Communications, Inc.*, 179 B.R. 544, 557, 26 Bankr. Ct. Dec. (CRR) 511 (Bankr. N.D. Ill. 1994) (recognizing that courts have varied widely in the general approach they have taken regarding the good faith defense).

[123]Bayou IV, 439 B.R. at 314.

[124]Bayou IV, 439 B.R. at 315.

[125]Bayou IV, 439 B.R. at 315.

[126]Bayou IV, 439 B.R. at 315.

of numerous cases holding that courts must apply an objective test to . . . [the] diligent investigation components of the good faith test."[127] The court also held that the bankruptcy court committed legal error when it excluded as irrelevant evidence of whether a "diligent investigation would have led to the discovery of Bayou's fraudulent purpose and/or insolvency" in circumstances such as those present in Bayou where the "good faith" defense was raised by defendants who had not detected fraud.[128] The district court held that "where the fraud was not discovered, a transferee is entitled to offer evidence and to argue to the finder of fact that no diligent investigation would have disclosed the transferor's insolvency or fraudulent purpose."[129]

The district court addressed the three "red flags" alleged by the debtor and found that they were insufficient to place the investors on inquiry notice of Bayou's insolvency or fraudulent purpose using the proper standards for reviewing a good faith defense.[130] First, the district court found that investors' knowledge of a complaint, filed by a disgruntled former employee, which failed to plead fraud or suggest insolvency, was an insufficient basis to conclude as a matter of law that the investors were on inquiry notice of the scheme.[131] Second, the district court held that questions concerning the NAV calculation[132] for Bayou were insufficient to rule as a matter of law that a reasonable institutional hedge fund investor would have suspected that Bayou might be insolvent or that any transfer received from Bayou was made for a fraudulent purpose.[133] Finally, with respect to negative information about Bayou's founders in background investigation reports, the district court held that while these reports revealed matters that might cause one to be concerned about the moral integrity of Bayou's principals, the information was not sufficient to

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[127]Bayou IV, 439 B.R. at 317.

[128]Bayou IV, 439 B.R. at 317.

[129]Bayou IV, 439 B.R. at 317.

[130]Bayou IV, 439 B.R. at 318. *See* note 116 for a discussion of the "red flags" alleged by the debtor.

[131]Bayou IV, 439 B.R. at 322–23.

[132]The NAV calculation issue arose as a result of an outside investment advisor's request for confirmation that Bayou's offshore administrator was independently computing or verifying the NAV calculations provided monthly by Bayou. Bayou IV, 439 B.R. at 324. That outside investment advisor became concerned about the NAV calculation due to the refusal by one of Bayou's principals to allow a review of Bayou's prime broker statements, which could be used to independently verify the NAV. Bayou IV, 439 B.R. at 324.

[133]Bayou IV, 439 B.R. at 327.

support a finding as a matter of law that a reasonable institutional hedge fund investor "would have suspected that Bayou might be insolvent or that any transfer obtained from Bayou might be made for a fraudulent purpose."[134]

d. Avoidance of Transfers Relating to Fictitious Profits as Constructively Fraudulent

The final issue examined in *Bayou IV* was the bankruptcy court's grant of summary judgment in favor of the debtors on claims asserting constructive fraudulent transfer "to the extent that [the Appellant investors'] redemption payments included fictitious profits."[135] The district court noted that actions to avoid constructively fraudulent transfers under section 548(a)(1)(B) of the Bankruptcy Code are "based on the transferor's financial condition and the sufficiency of the consideration provided by the transferee, *not on fraud*."[136] Relying on *Scholes v. Lehmann*, the district court found that the bankruptcy court made no error in finding that the investors "provided no value in exchange for the fictitious profits they received" and that the portion of their redemption that included fictitious profits was thus an avoidable constructively fraudulent transfer.[137]

The Bayou investors have commenced an appeal of the district court's decision in *Bayou IV* to the Second Circuit solely with respect to the order affirming the bankruptcy court's grant of summary judgment on Bayou's claim for avoidance of transfers relating to fictitious profits.[138] This appeal is likely to be carefully considered by the Second Circuit in light of the substantial avoidance litigation that is pending in the Madoff SIPA[139] proceedings, as well as litigation pending in other Ponzi scheme insolvencies in the Second Circuit and other jurisdictions.

As a result of *Bayou IV*, summary judgment often may be

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[134]Bayou IV, 439 B.R. at 327–28.

[135]Bayou IV, 439 B.R. at 329. As noted above, fictitious profits are payments in excess of the principal amount invested.

[136]Bayou IV, 439 B.R. at 330 (emphasis added) (quoting *In re Verestar, Inc.*, 343 B.R. 444, 460 (Bankr. S.D. N.Y. 2006)).

[137]Bayou IV, 439 B.R. at 338 (citing *Scholes v. Lehmann*, 56 F.3d 750, 757 (7th Cir. 1995) (holding that an investor in a Ponzi scheme was required to return his fictitious profits as a fraudulent conveyance because "[h]e should not be permitted to benefit from a fraud at their [the other investors] expense merely because he was not himself to blame for the fraud.")).

[138]Notice of Appeal to the United States Court of Appeals for the Second Circuit at 1, *In re Bayou Group, LLC*, 439 B.R. 284 (S.D. N.Y. 2010).

[139]An explanation of SIPA is provided at note 141 below.

precluded when a Ponzi scheme investor asserts the good faith defense due to issues of fact as to whether the investor was on inquiry notice of fraud or insolvency. However, even if a Ponzi scheme investor can establish good faith for the purpose of section 548(c) in order for the affirmative defense to succeed, the investor still must show that it provided value to the debtor. This requirement may limit investors to retain only the principal amounts invested. Unless reversed by the Second Circuit or absent a statutory change, it appears that *Bayou IV's* ruling with respect to fictitious profits will limit the benefit of a section 548(c) good faith defense because even "good faith" investors to Ponzi schemes "provided no value in exchange for the fictitious profits they received."[140]

2. *Picard v. Merkin*

The Ponzi scheme perpetrated by Bernard Madoff involved the transfer of billions of dollars in fictitious profits to certain investors in his scheme. Irving Picard, the court-appointed trustee overseeing the SIPA liquidation[141] of Madoff's firm, Bernard L. Madoff Investment Securities, LLC ("BLMIS"), has commenced hundreds of lawsuits seeking to avoid these transfers as fraudulent under both the Bankruptcy Code and New York's Debtor Creditor Law.

In November of 2010, the Bankruptcy Court for the Southern District of New York denied motions to dismiss the avoidance actions commenced by Irving Picard against Ezra Merkin and several of the funds he controlled.[142] The *Picard v. Merkin* decision addressed motions filed by Ezra Merkin and the investment funds that he controlled (collectively the "Merkin Defendants") seeking the dismissal of the trustee's fraudulent transfer actions for the

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[140]Bayou IV, 439 B.R. at 338.

[141]Congress enacted the Securities Investor Protection Act ("SIPA") in 1970 for the primary purpose of protecting customers from losses caused by the insolvency or financial instability of broker-dealers. *See In re Bernard L. Madoff Inv. Securities LLC*, 424 B.R. 122, 132, Bankr. L. Rep. (CCH) P 81726 (Bankr. S.D. N.Y. 2010), aff'd, 2011 WL 3568936 (2d Cir. 2011) (citing *Securities and Exchange Commission v. S. J. Salmon & Co., Inc.*, 375 F. Supp. 867, 871, Fed. Sec. L. Rep. (CCH) P 94582 (S.D. N.Y. 1974)). SIPA establishes procedures for liquidating failed broker dealers and provides customers of broker dealers with special protections. Bernard L. Madoff Inv. Securities LLC, 424 B.R. at 132–33. A SIPA liquidation is essentially a bankruptcy liquidation tailored to achieve SIPA's objectives. Bernard L. Madoff Inv. Securities LLC, 424 B.R. at 133 (citing 15 U.S.C.A. § 78fff(b)).

[142]*In re Bernard L. Madoff Inv. Securities, LLC*, 440 B.R. 243, 64 Collier Bankr. Cas. 2d (MB) 957 (Bankr. S.D. N.Y. 2010).

avoidance and recovery of transfers totaling over $490 million.[143] According to the facts alleged in the complaint against the Merkin Defendants, Ezra Merkin was a sophisticated investment manager who, both personally and through the funds he controlled, withdrew hundreds of millions of dollars from BLMIS in the years prior to the exposure of the Madoff Ponzi scheme.[144] The complaint alleged that the Merkin Defendants received the transfers in bad faith, as they were "on notice of certain 'red flags' indicating fraudulent activity, failed to exercise due diligence, and knew or should have known that they were profiting from a fraudulent scheme."[145]

a. Assertion of Good Faith Defense Was at Best Premature

In support of their motions to dismiss the trustee's claims that the redemption payments were actually fraudulent pursuant to section 548(a)(1)(A), the Merkin Defendants argued that the redemption payments were protected by the good faith defense provided in section 548(c) of the Bankruptcy Code.[146] The bankruptcy court refused to consider the Merkin Defendants' invocation of the good faith defense as premature for a motion to dismiss.[147] Relying on, *inter alia*, the *Bayou IV* decision, the bankruptcy court noted that the Ponzi scheme presumption established that all transfers made by BLMIS were made with actual intent to hinder, delay, and defraud creditors.[148] The bankruptcy court emphasized that it is not the trustee's burden to establish good faith, as section 548(c) provided an affirmative defense.[149] Assuming, however, that the defense was appropriately raised in a motion to dismiss, the bankruptcy court refused to dismiss the action against the Merkin Defendants because the determination of good faith is a factual question, and the factual allegations of the complaint, accepted as true at the motion to dismiss stage,

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[143]Bernard L. Madoff Inv. Securities LLC, 440 B.R. at 249–50.

[144]Bernard L. Madoff Inv. Securities LLC, 440 B.R. at 251. The amounts withdrawn exceeded the principal amounts invested by the Merkin Defendants.

[145]Bernard L. Madoff Inv. Securities LLC, 440 B.R. at 252–53.

[146]The bankruptcy court found that the trustee's claims asserting actual fraudulent transfer under section 548(a)(1)(A) of the Bankruptcy Code were sufficiently pled to withstand a motion to dismiss. Bernard L. Madoff Inv. Securities LLC, 440 B.R. at 255.

[147]Bernard L. Madoff Inv. Securities LLC, 440 B.R. at 256.

[148]Bernard L. Madoff Inv. Securities LLC, 440 B.R. at 255.

[149]Bernard L. Madoff Inv. Securities LLC, 440 B.R. at 256 (citing *In re Manhattan Investment Fund Ltd.*, 310 B.R. 500, 508 (Bankr. S.D. N.Y. 2002)).

included "allegations that the Moving Defendants accepted the . . . [t]ransfers in *bad faith*, with both actual and constructive knowledge of the fraud."[150]

b. The Merkin Defendants Could Not Assert Restitution Claims

In seeking to dismiss the trustee's claim that payments in redemption of their investments were constructively fraudulent transfers pursuant to section 548(a)(1)(B), the Merkin Defendants argued that the payments were in exchange for reasonably equivalent value because they were in satisfaction of antecedent debt arising from their restitution claims.[151] The bankruptcy court rejected the Merkin Defendants' argument that they had provided BLMIS with "reasonably equivalent value" for their redemptions of principal which asserted that, as innocent investors, the Merkin Defendants held state law fraudulent inducement claims against BLMIS that entitled them to restitution and that such restitution claims created antecedent debt that constituted reasonable equivalent value for the redemption payments.[152] The bankruptcy court found this argument was misplaced because only innocent investors are entitled to restitution.[153] Since the trustee had sufficiently pled that the Merkin Defendants were not innocent investors, they would not be entitled to the equitable right of restitution and therefore could not rely on restitution claims to demonstrate reasonably equivalent value in defense of claims alleging constructive fraud. Ultimately, the bankruptcy court determined that the question of reasonably equivalent value was one of fact, inappropriate for a motion to dismiss and held

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[150]Bernard L. Madoff Inv. Securities LLC, 440 B.R. at 256 (emphasis in original).

[151]The bankruptcy court denied the Merkin Defendants' motion to dismiss the constructive fraud claims, finding that the trustee's claims were adequately pled. Bernard L. Madoff Inv. Securities LLC, 440 B.R. at 261–62 (citing *In re Actrade Financial Technologies Ltd.*, 337 B.R. 791, 801 (Bankr. S.D. N.Y. 2005)). Similar to the recent decisions from Delaware discussed in section III.B. of this Article, the bankruptcy court addressed the appropriate pleading standard for constructive fraud and found that "[t]he heightened federal pleading standard for allegations of fraud does not apply to a complaint to avoid transfers as constructively fraudulent." Bernard L. Madoff Inv. Securities LLC, 440 B.R. at 261–62.

[152]Bernard L. Madoff Inv. Securities LLC, 440 B.R. at 262.

[153]Bernard L. Madoff Inv. Securities LLC, 440 B.R. at 262–63.

that the trustee had adequately pled lack of reasonably equivalent value for the purposes of section 548(a)(1)(B).[154]

c. The Safe Harbor of Section 546(e) Is Not Applicable to Ponzi Scheme Redemption Payments

Finally, the Merkin Defendants argued that their redemption payments were insulated from liability for constructive fraud claims by the safe harbor provided by section 546(e) of the Bankruptcy Code.[155] Specifically, the Merkin Defendants asserted that the transfers from BLMIS to their accounts at JPMorgan were "made by a stockbroker to a financial institution pursuant to a securities contract, and thus cannot be avoided."[156] The bankruptcy court found that the Merkin Defendants' assertion of the safe harbor defense was at best premature because section 546(e) provides an affirmative defense. Further, even if the defense were timely, the court could not find as a matter of law that section 546(e) applied to the transactions at issue.[157] The bankruptcy court disagreed with the Merkin Defendants' argument that BLMIS qualified as a "stockbroker" for purposes of section 546(e), reasoning that Ponzi scheme operators do not affirmatively make securities trades on behalf of legal customers, and therefore do not satisfy the definition of "stockbroker" for purposes of section 546(e).[158] Additionally, the court questioned whether the account agreements between the Merkin Defendants and BLMIS were in fact "securities contracts" as such term is defined under the Bankruptcy Code. Indeed, the bankruptcy court observed that at most

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[154]In declining to grant the motion to dismiss allegations of constructive fraud under state law, the bankruptcy court found the Merkin Defendants' reliance on *Sharp* misplaced because, unlike the defendants in *Sharp*, the Merkin Defendants were not "innocent" when they invested in BLMIS. Bernard L. Madoff Inv. Securities LLC, 440 B.R. at 265–66 (citing Sharp, 403 F.3d at 55).

[155]Bernard L. Madoff Inv. Securities LLC, 440 B.R. at 266. Section 546(e) of the Bankruptcy Code, which is commonly known as the safe harbor section, provides, in relevant part, that "the trustee may not avoid . . . a transfer made by or to (of for the benefit of) a . . . stockbroker . . . [or] financial institution . . . in connection with a securities contract." 11 U.S.C.A. § 546(e).

[156]Bernard L. Madoff Inv. Securities LLC, 440 B.R. at 266.

[157]Bernard L. Madoff Inv. Securities LLC, 440 B.R. at 266–67.

[158]Bernard L. Madoff Inv. Securities LLC, 440 B.R. at 267 (citing *In re Slatkin*, 525 F.3d 805, 817, 49 Bankr. Ct. Dec. (CRR) 267, 76 Fed. R. Evid. Serv. 495 (9th Cir. 2008)). The bankruptcy court also noted that BLMIS "never in fact purchased any of the securities he claimed to have purchased for customer accounts" and that there was no record of BLMIS ever having cleared a single purchase or sale of securities. Bernard L. Madoff Inv. Securities LLC, 440 B.R. at 267.

the account agreements "merely *authorize[d]* one party, Madoff, to act as agent . . . to buy, sell and trade in stocks, bonds, options and any other securities in the future on the Fund Defendants' behalf"[159] and suggested that, in Ponzi scheme cases, the extension of the safe harbor would undermine, and not promote, investor confidence and thus concluded that "the safe harbor provision does not insulate transactions like these from attack."[160]

The Merkin Defendants are currently appealing virtually every issue decided by the bankruptcy court in *Picard v. Merkin*.[161]

The bankruptcy court's decision in *Picard v. Merkin* indicates, among other things, that the nature of the transferee is significant for purposes of examining the assertion of a good faith defense in the context of a motion to dismiss claims alleging that transfers are actually fraudulent. In addition, the decision also implies that the nature of the transferee may be relevant to whether a restitution claim may be asserted for purposes of demonstrating the provision of "reasonably equivalent value" in response to claims asserting constructive fraud. Further, the decision suggests that the safe harbor of section 546(e) may not apply in Ponzi scheme cases where the scheme is run through a fund or a broker-dealer. If the determinations in *Picard v. Merkin* withstand appeal, they should strengthen the Madoff trustee's position against defendants in recently filed adversary proceedings, making the reallocation of assets to Madoff investors likely.[162] Specifically, *Picard v. Merkin* could serve as a warning that those who are not innocent investors or who invest through

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[159]Bernard L. Madoff Inv. Securities LLC, 440 B.R. at 267 (emphasis in original).

[160]Bernard L. Madoff Inv. Securities LLC, 440 B.R. at 267–68 (quoting *In re Adler, Coleman Clearing Corp.*, 247 B.R. 51, 105 (Bankr. S.D. N.Y. 1999), judgment aff'd, 263 B.R. 406, 44 U.C.C. Rep. Serv. 2d 1125 (S.D. N.Y. 2001).

[161]For a list of the issues on appeal, *see* Memorandum of Law in Support of Motion of Bart M. Schwartz, as Receiver of Defendants Gabriel Capital, L.P. and Ariel Fund Limited, for Leave to Appeal the November 17, 2010, Memorandum Decision and Order Granting in Part and Denying in Part Defendants' Motions to Dismiss Trustee's Complaint at 8–9, *In re Bernard L. Madoff Inv. Securities, LLC*, 440 B.R. 243, 64 Collier Bankr. Cas. 2d (MB) 957 (Bankr. S.D. N.Y. 2010), *appeal docketed*, No. 09-1182 (BRL) (S.D.N.Y. Dec. 1, 2010).

[162]Proposed legislation, that has been referred to the House Committee on Financial Services, could potentially limit the power of court-appointed trustees marshalling assets of bankrupt brokerages, such as in the Madoff case, to begin clawback suits against those defendants that are "net winners." Equitable Treatment of Investors Act, H.R. 6531, 111th Cong. (2d Sess. 2010). H.R. 6531, 111th Cong. would amend the 1970 Securities Investor Protection Act (SIPA) to

other non-innocent investors in a Ponzi scheme may be required to relinquish their principal amount invested, in addition to their fictitious profits.

B. Enhanced Pleading Standards of *Twombly* and *Iqbal* in Fraudulent Transfer Actions

The successful prosecution or defense of avoidance actions commenced in bankruptcy cases requires compliance with the pleading standards set forth in both the Federal Rules of Civil Procedure ("Fed. R. Civ. P.") and the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules"). The Bankruptcy Rules that govern pleading standards incorporate the provisions of the Fed. R. Civ. P. Following the United States Supreme Court's decisions in *Bell Atlantic Corp. v. Twombly* ("*Twombly*")[163] and *Ashcroft v. Iqbal* ("*Iqbal*"),[164] the requirements of Bankruptcy Rules 7008 and 7009 which make applicable Fed. R. Civ. P. 8 and 9 in adversary proceedings have been the focus of numerous recent decisions in avoidance actions.[165]

The Supreme Court's ruling in *Twombly* articulated a new, heightened standard for stating a claim in a complaint filed in

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require that trustees determine claims of loss according to final account statements, except where the claimant knew that the failed broker-dealer was involved in fraud. This proposed change would update the current law, which does not specify the formula for calculating the amount of a claim.

[163] *Bell Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 127 S. Ct. 1955, 167 L. Ed. 2d 929, 2007-1 Trade Cas. (CCH) ¶ 75709, 68 Fed. R. Serv. 3d 661 (2007). *Twombly* involved a complaint filed by a group of telecommunications consumers who brought a class action lawsuit alleging antitrust conspiracy against a number of local exchange carriers.

[164] *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 173 L. Ed. 2d 868, 2009-2 Trade Cas. (CCH) ¶ 76785, 73 Fed. R. Serv. 3d 837 (2009). *Iqbal* involved a foreign detainee's complaint against United States government officials alleging a series of unconstitutional actions during his imprisonment.

[165] Bankruptcy Rule 7008(a) provides in relevant part:

> Rule 8 F.R. Civ. P. applies in adversary proceedings.
>
> Fed. R. Bankr. P. 7008(a).

Rule 8 of the FRCP provides in relevant part:

> (a) Claims for Relief.
>
> A pleading that states a claim for relief must contain:
>
> (1) a short and plain statement of the grounds for the court's jurisdiction, unless the court already has jurisdiction and the claim needs no new jurisdictional support;
>
> (2) a short and plain statement of the claim showing that the pleader is entitled to relief; and
>
> (3) a demand for the relief sought, which may include relief in the alternative or different types of relief.
>
> Fed. R. Civ. P. 8(a).

federal court.[166] The central holding of *Twombly* was that a complaint must contain sufficient facts to state a claim for relief that is "*plausible on its face*," otherwise the claim will be subject to dismissal.[167] Additionally, the grounds for relief require "more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do . . ."[168] Importantly, factual allegations must be sufficient to "raise a right to relief above the speculative level."[169] The Supreme Court further articulated the pleadings requirements for a complaint filed in federal court with its ruling in *Iqbal*. *Iqbal* made it clear that only a complaint that states a "plausible claim" will survive a motion to dismiss.[170] The Supreme Court clarified further that a claim has facial plausibility "when the pleaded factual content allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged."[171] The determination of whether a complaint meets this standard of plausibility is extremely context-specific.[172]

Both *Twombly* and *Iqbal* have triggered a re-examination of the standards applicable to complaints filed in avoidance actions in bankruptcy cases. Indeed, a number of recent cases have discussed the applicability of the holdings of *Twombly* and *Iqbal*

Bankruptcy Rule 7009 provides that "Rule 9 F.R. Civ. P. applies in adversary proceedings." Fed. R. Bankr. P. 7009.

Rule 9 of the FRCP provides in relevant part:

> (b) *Fraud or Mistake; Conditions of Mind*. In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally.

Fed. R. Civ. P. 9(b).

[166] *Twombly* supplanted the previous standard, which permitted the dismissal of a complaint for failure to state a claim only if 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, 46, 78 S. Ct. 99, 2 L. Ed. 2d 80, 9 Fair Empl. Prac. Cas. (BNA) 439, 41 L.R.R.M. (BNA) 2089, 1 Empl. Prac. Dec. (CCH) P 9656, 33 Lab. Cas. (CCH) P 71077 (1957) (abrogated by, Bell Atlantic Corp. v. Twombly, 550 U.S. 544, 127 S. Ct. 1955, 167 L. Ed. 2d 929, 2007-1 Trade Cas. (CCH) ¶ 75709, 68 Fed. R. Serv. 3d 661 (2007)).

[167] Twombly, 550 U.S. at 570 (emphasis added).

[168] Twombly, 550 U.S. at 555.

[169] Twombly, 550 U.S. at 555.

[170] Iqbal, 129 S. Ct. at 1949.

[171] Iqbal, 129 S. Ct. at 1940.

[172] Iqbal, 129 S. Ct. at 1950.

in such a context.[173] Three recent Delaware Bankruptcy Court decisions, *In re Aphton Corp.*,[174] *In re Mervyn's*[175] and *In re Pillowtex Corp.*,[176] specifically addressed the applicability of heightened pleading standards to fraudulent conveyance actions.

1. *In re Aphton Corp.*

In *In re Aphton Corp.* ("*Aphton*"), the bankruptcy court reviewed, solely pursuant to Fed. R. Civ. P. 9(b) and Bankruptcy Rule 7009, motions to dismiss a trustee's seven-count complaint that (a) sought to avoid and recover three alleged constructive fraudulent transfers made to Sanofi Pasteur Limited, Aventis Pharmaceuticals (collectively, "Aventis"), and former noteholders, and (b) alleged that such transfers were made in exchange for less than reasonably equivalent value.[177] In addition, the complaint alleged that these same transfers were avoidable under applicable state law pursuant to section 544 of the Bankruptcy Code.[178] The bankruptcy court denied dismissal on two of the counts because those claims were facially plausible, and granted

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[173] *See, e.g.,* Picard v. Merkin, 440 B.R. at 253–54 (allegations of actual fraud are held to the higher pleading standards of Fed. R. Civ. P. 9(b)); *In re Charys Holding Co., Inc.*, 2010 WL 2788152 (Bankr. D. Del. 2010) (preference complaint dismissed for failing to allege facts showing the existence of an antecedent debt); *In re CLK Energy Partners, LLC*, 2010 WL 1930065 (Bankr. W.D. La. 2010) (dismissal of a fraudulent transfer count granted with leave to amend, due to the complainant's failure to identify the non-bankruptcy law on which the section 544(b) claim was grounded); *In re Caremerica, Inc.*, 409 B.R. 737, 51 Bankr. Ct. Dec. (CRR) 249 (Bankr. E.D. N.C. 2009) (dismissal of complaint to avoid alleged fraudulent and preferential transfers granted, with right to amend, due to insufficient allegations of the dates and amounts of the allegedly preferential transfers and the failure to allege specific facts supporting allegations that the debtor was insolvent and failed to receive reasonably equivalent value for the transfers at issue); *In re Troll Communications, LLC*, 385 B.R. 110, 49 Bankr. Ct. Dec. (CRR) 236 (Bankr. D. Del. 2008) (dismissal of complaint brought under sections 547 and 548 of the Bankruptcy Code denied where plaintiff supported the allegations with specific facts and not mere conclusory statements).

[174] *In re Aphton Corp.*, 423 B.R. 76 (Bankr. D. Del. 2010).

[175] *In re Mervyn's Holdings, LLC*, 426 B.R. 488 (Bankr. D. Del. 2010).

[176] *In re Pillowtex Corp.*, 427 B.R. 301 (Bankr. D. Del. 2010).

[177] In re Aphton Corp., 423 B.R. at 83–4. Aventis was a biopharmaceutical company that developed products for the treatment of cancer.

[178] In re Aphton Corp., 423 B.R. at 87–8.

dismissal on four of the counts because they did not satisfy heightened pleading standards.[179]

Specifically, the trustee sought to avoid a prepetition agreement and related supply agreements between Aphton and Aventis (the "Termination Agreement"). In exchange for entering into the Termination Agreement, Aventis forgave $1.8 million in receivables owed by Aphton and in return Aphton agreed to terminate its licensing, manufacturing, and supply agreements with Aventis.[180] The trustee also sought avoidance of Aphton's prepetition $3 million payment to Aventis to redeem convertible debentures having a principal amount of $3 million (the "Redemption Payment").[181] Finally, the trustee sought to avoid Aphton's transfer, to the former noteholders, of cash in the amount of $3 million and common stock to redeem notes in the face amount of $15 million issued pursuant to a prepetition exchange agreement (the "Exchange Agreement").[182] In response, the former noteholders and Aventis filed separate motions to dismiss the trustee's complaint for failure to state a claim upon which relief can be granted.[183]

The court observed that *Twombly* and *Iqbal* served to raise the pleading standards from simple notice pleading to a more heightened form of pleading that required a plaintiff to plead more than the possibility of relief to survive a motion to dismiss.[184] Accordingly, the court reviewed the complaint to determine whether the allegations satisfied the heightened fraud pleading requirement of Bankruptcy Rule 7009, and whether each count satisfied the "facially plausible" standard.[185]

With respect to the counts asserted pursuant to section 544 of

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[179]One count was dismissed upon stipulation of the parties. In re Aphton Corp., 423 B.R. at 80 n.3.

[180]In re Aphton Corp., 423 B.R. at 81–2 & 91 n.62.

[181]In re Aphton Corp., 423 B.R. at 82–3.

[182]In re Aphton Corp., 423 B.R. at 83–4.

[183]In re Aphton Corp., 423 B.R. at 84. The motions were made under Fed. R. Civ. P. 12(b)(6), as made applicable by Bankruptcy Rule 7012.

[184]The Third Circuit Court of Appeals articulated a two-part analysis following *Iqbal*, whereby the court must (a) first separate the factual and legal elements of a claim, and must accept all of the complaint's well-pleaded facts as true, but may disregard any legal conclusions; and (b) then determine whether the facts alleged in the complaint are sufficient to show that the plaintiff has a plausible claim for relief. In re Aphton Corp., 423 B.R. at 86 (quoting *Fowler v. UPMC Shadyside*, 578 F.3d 203, 210–11, 22 A.D. Cas. (BNA) 353 (3d Cir. 2009)).

[185]In re Aphton Corp., 423 B.R. at 86–7. However, the court acknowledged that trustees, as third-party outsiders, are generally provided with a more lib-

the Bankruptcy Code claiming that the $3 million transfer to the former noteholders and the $3 million transfer to Aventis violated applicable state fraudulent transfer law,[186] the court found that these counts did not satisfy Bankruptcy Rule 7009[187] and granted the dismissal because the counts were supported by mere "blanket assertions" that failed to state the grounds upon which the claims were based.[188]

The court next examined the counts alleging constructive fraud, with respect to the Termination Agreement and the Redemption Payment, pursuant to section 548(a)(2) of the Bankruptcy Code, and concluded that the claims satisfied Fed. R. Civ. P. 9(b), because they: (1) asserted the legal elements of a fraudulent conveyance, (2) relied upon specific facts in framing the claims, (3) included the face amount of the transfers, and (4) contained allegations of the date, time and place of the transfers.[189] In so doing, the court applied the standards articulated in *Twombly* and *Iqbal* to the counts brought under section 548(a)(2) of the Bankruptcy Code. The court identified two elements that must be facially plausible from the complaint in order for a constructive fraudulent transfer claim to survive a motion to dismiss: (1) the debtor's insolvency when the transfer was made; and (2) whether the debtor received reasonably equivalent value for the transfer.[190] The factors relevant to the determination of whether reasonably equivalent value exists include: (1) the fair market value of the benefit received as a result of the transfer; (2) the existence of an

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eral pleading standard under Bankruptcy Rule 7009. In re Aphton Corp., 423 B.R. at 85. Despite this, the court cautioned that the trustee still must do more than merely identify the allegedly fraudulent transfers. In re Aphton Corp., 423 B.R. at 85. A number of cases discuss the liberal pleading standards afforded bankruptcy trustees. *See generally* Picard v. Merkin, 440 B.R. at 254; *In re Fedders North America, Inc.*, 405 B.R. 527, 544 (Bankr. D. Del. 2009); *In re Global Link Telecom Corp.*, 327 B.R. 711, 717 (Bankr. D. Del. 2005); *In re Oakwood Homes Corp.*, 325 B.R. 696, 698 (Bankr. D. Del. 2005); *In re Randall's Island Family Golf Centers, Inc.*, 290 B.R. 55, 65 (Bankr. S.D. N.Y. 2003).

[186]In re Aphton Corp., 423 B.R. at 87. The applicable state law was the Pennsylvania and Delaware versions of the Uniform Fraudulent Transfer Act.

[187]In re Aphton Corp., 423 B.R. at 87–8. The language of Bankruptcy Rule 7009 is provided in note 165.

[188]In re Aphton Corp., 423 B.R. at 87.

[189]In re Aphton Corp., 423 B.R. at 88. Instrumental to this determination was the trustee's attachment of supporting documents.

[190]In re Aphton Corp., 423 B.R. at 89. The court noted that it must accept the trustee's allegation of the debtor's insolvency at the time of the transfer; therefore, whether the debtor was insolvent was not at issue. In re Aphton Corp., 423 B.R. at 90.

arm's-length relationship between the debtor and the transferee; and (3) the transferee's good faith.[191]

Applying these factors to constructive fraud allegations with respect to the Redemption Payment and Termination Agreement, the court held that dismissal of these claims was proper.[192] Specifically, the court found that the allegations contained in the complaint were not only contradicted by the documents attached to the complaint, but were also inconsistent with respect to the facts of the Termination Agreement and the Redemption Payment.[193] As a result, the court held that it need not accept as true the complaint's allegations.[194] Additionally, the court noted that even if these allegations were accepted as true, the complaint "lack[ed] sufficient factual allegations to determine which transaction was [for] less than reasonably equivalent value."[195]

Next, the court denied the former noteholders' motion to dismiss with respect to the $3 million paid pursuant to the Exchange Agreement. As a preliminary matter, the court determined that, because it was reviewing a motion to dismiss, it was premature to consider whether the Exchange Agreement was entered into to satisfy an antecedent debt that would constitute reasonably equivalent value.[196] In so ruling, the court noted that it may only consider "whether the Complaint is facially plausible, and cannot, at this time, consider possible defenses to the allegations in the Complaint."[197] The court found that the trustee's allegations that the noteholders had not provided reasonably equivalent value for the Exchange Agreement were facially plausible, since the complaint alleged that Aphton was insolvent at the time the Exchange Agreement was executed. Therefore, the court noted that "it must follow that the notes and

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[191]In re Aphton Corp., 423 B.R. at 89.

[192]In re Aphton Corp., 423 B.R. at 90–1.

[193]In re Aphton Corp., 423 B.R. at 90–1. For example, the court noted that the Termination Agreement did not indicate a $3 million transfer. In re Aphton Corp., 423 B.R. at 90–1. Additionally, the court notes that, "If the allegations of [the] complaint are contradicted by documents made a part thereof, the document controls and the court need not accept as true the allegations of the complaint." In re Aphton Corp., 423 B.R. at 90 n.59 (quoting *In re SHC, Inc.*, 329 B.R. 438, 442, 45 Bankr. Ct. Dec. (CRR) 98, 58 U.C.C. Rep. Serv. 2d 573 (Bankr. D. Del. 2005)).

[194]In re Aphton Corp., 423 B.R. at 91.

[195]In re Aphton Corp., 423 B.R. at 91.

[196]In re Aphton Corp., 423 B.R. at 93.

[197]In re Aphton Corp., 423 B.R. at 93.

the shares . . . were also worthless."[198] This was sufficient basis for the court to deny dismissal, because "all that is needed at this stage is an allegation that there was a transfer for less than reasonably equivalent value at a time when the Debtors were insolvent."[199]

The *Aphton* decision further reinforces *Iqbal*'s holding that *Twombly* applies to complaints filed in adversary proceedings and serves as a reminder that anything less than strict compliance with the heightened pleading standards could result in the dismissal of a complaint. Additionally, *Aphton* demonstrates that defendants should focus on the facial implausibility of the claims alleged when crafting their motions to dismiss. However, *Aphton* examined whether the complaint alleging constructive fraud satisfied the particular requirements of Fed. R. Civ. P. 9(b), unlike other courts reviewing motions to dismiss claims alleging constructive fraud who have determined that such complaints need to comply with the seemingly less stringent standards of Fed. R. Civ. P. 8(a)(2).

2. *In re Mervyn's Holdings, LLC* and *In re Pillowtex Corporation*

Following the Bankruptcy Court for the District of Delaware's decision in *Aphton*, two additional decisions from the same jurisdiction, *In re Mervyn's Holdings, LLC*[200] ("*Mervyn's*") and *In re Pillowtex Corporation*[201] ("*Pillowtex*"), further clarify the application of Fed. R. Civ. P. 8(a)(2) and 9(b) in the context of fraudulent transfer actions.

Mervyn's addressed motions to dismiss fraudulent transfer actions brought by a Chapter 11 debtor. In its complaint, Mervyn's alleged that its former parent company, Target Corporation ("Target"), was liable for the fraudulent transfer of assets, under theories of both constructive and actual fraud, as a result of Target's sale of the debtor to a number of private equity groups.

While finding that the debtor had asserted viable claims for actual and constructive fraud, the court clarified that the standards for successfully pleading claims asserting actual fraudulent transfer are more difficult to satisfy than those for constructive

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[198] In re Aphton Corp., 423 B.R. at 93.

[199] In re Aphton Corp., 423 B.R. at 93 (quoting *In re DVI, Inc.*, 50 Bankr. Ct. Dec. (CRR) 159, 2008 WL 4239120, *9 (Bankr. D. Del. 2008)).

[200] *In re Mervyn's Holdings, LLC*, 426 B.R. 488 (Bankr. D. Del. 2010).

[201] *In re Pillowtex Corp.*, 427 B.R. 301 (Bankr. D. Del. 2010).

fraud.[202] In doing so, the court determined that Fed. R. Civ. P. 9(b) "only applies to allegations of actual fraud."[203] Additionally, the court found that claims of constructive fraud are evaluated using Fed. R. Civ. P. 8(a)(2) (rather than Fed. R. Civ. P. 9(b) as was required in *Aphton*).[204]

Just one month later, the *Pillowtex* court reaffirmed the *Mervyn's* holding that constructive and actual fraud should be evaluated under different pleading standards. *Pillowtex* involved a constructive fraudulent transfer complaint, asserting claims under sections 548 and 550, filed by the liquidating trustee of Pillowtex, a large textile manufacturer, against Classic Packaging Company ("Classic"), one of Pillowtex's vendors. Classic sought, among other things, the dismissal of the constructive fraudulent transfer action under a theory that the liquidating trustee's complaint failed to satisfy the stringent pleading requirements under Fed. R. Civ. P. 9(b) and failed to state a claim for purposes of Fed. R. Civ. P. 12(b)(6).[205]

In holding that the dismissal of the constructive fraud claim was proper, the court first recognized the applicability of heightened pleading standards as confirmed by *Twombly* and *Iqbal*. It then cited to *Mervyn's* for the proposition that while actual fraud is evaluated under Fed. R. Civ. P. 9(b), constructive fraud claims are evaluated under Fed. R. Civ. P. 8(a)(2).[206] The court found that, in this instance, the complaint merely "recite[d] the statutory language of section 548(a) of the Bankruptcy Code and completely lack[ed] any factual allegations to support a

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[202]In re Mervyn's Holdings, LLC, 426 B.R. at 498.

[203]In re Mervyn's Holdings, LLC, 426 B.R. at 495.

[204]In re Mervyn's Holdings, LLC, 426 B.R. at 495 (citing *In re Plassein Intern. Corp.*, 352 B.R. 36 (Bankr. D. Del. 2006)) (the court evaluated fraudulent transfer complaints using Fed. R. Civ. P. 8(a)(2)'s notice pleading standard); *In re Ticketplanet.com*, 313 B.R. 46, 68 (Bankr. S.D. N.Y. 2004) ("While there is authority to the contrary, the better and majority rule is that a claim for constructive fraud . . . need not be pleaded with particularity . . ."); *In re White Metal Rolling and Stamping Corp.*, 222 B.R. 417, 429 (Bankr. S.D. N.Y. 1998) ("[T]he sole consideration should be whether, consistent with the requirements of Rule 8(a), the complaint gives the defendant sufficient notice to prepare an answer, frame discovery and defend against the charges."). *See also* Picard v. Merkin, 440 B.R. at 261–62 (noting that the heightened federal pleading standard does not apply to constructive fraudulent transfer allegations).

[205]In re Pillowtex Corp., 427 B.R. at 304.

[206]In re Pillowtex Corp., 427 B.R. at 310 (citing In re Mervyn's, 426 B.R. at 495).

fraudulent transfer claim."[207] Therefore, the court found that the complaint did not satisfy the pleading requirements set forth in *Twombly* and dismissed the complaint under Fed. R. Civ. P. 12(b)(6).[208]

Mervyn's and *Pillowtex* support *Aphton*'s holding that the *Twombly* and *Iqbal* pleading standards apply to complaints filed in fraudulent transfer actions. Importantly, *Mervyn's* and *Pillowtex* suggest that the heightened pleading standards, of Fed. R. Civ. P. 9(b), apply solely to claims of actual fraudulent transfer, as opposed to claims of constructively fraudulent transfer which need to be pled in accordance with Fed. R. Civ. P. 8.[209]

C. Severance Payments to Former Executives as Constructively Fraudulent Transfers

Congress amended section 548(a)(1) of the Bankruptcy Code as part of BAPCPA in the aftermath of high-profile bankruptcy cases such as *Enron* and *WorldCom* to make it clear that debtors or their estates can recapture, as fraudulent transfers, extraordinary payments made to insiders during the two-year period leading up to the bankruptcy filing.[210] Congress added a new subsection (IV) to section 548(a)(1)(B) that provides an additional basis for finding a transfer constructively fraudulent, *i.e.,* when a debtor "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."[211] Notably, when section 548(a)(1)(B)(ii)(IV) applies, only lack of rea-

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[207] In re Pillowtex Corp., 427 B.R. at 311.

[208] In re Pillowtex Corp., 427 B.R. at 311. Noting that the complaint had been filed prior to the Supreme Court's *Twombly* decision, the bankruptcy court granted the trustee leave to amend the complaint to set forth adequate facts to support the fraudulent transfer claims. In re Pillowtex Corp., 427 B.R. at 311 n.12.

[209] The standard of review articulated in *Mervyn's* and *Pillowtex* has recently been cited with approval by the Bankruptcy Court for the Southern District of Texas. *See In re Juliet Homes, LP*, 2010 WL 5256806, *6 n.6 (Bankr. S.D. Tex. 2010) (holding that "constructive fraudulent transfer claims are governed by [FRCP] 8(a)(2) rather than [FRCP] 9(b)") (citing *Pillowtex*, 427 B.R. at 310).

[210] *See* Pub. L. No. 109-8, § 1402 (2005). The specific amendments to section 548(a) made by BAPCPA are discussed at section II.A. of this Article.

[211] Pub. L. No. 109-8, § 1402 (2005).

sonably equivalent value must be shown and it is unnecessary for the estate or trustee to demonstrate insolvency.[212]

Two noteworthy 2010 decisions hold that severance payments made to former officers pursuant to agreements executed within two years of their companies' bankruptcy filings were outside of the ordinary course of business and avoidable as constructively fraudulent transfers. These decisions indicate that courts may have little difficulty finding that generous payments to outgoing executives are extraordinary and not in exchange for reasonably equivalent value: *In re TransTexas Gas Corp.*[213] ("*TransTexas*") and *In re TSIC, Inc.*[214] *("TSIC*").

1. *In re TransTexas Gas Corp.*

In *TransTexas*, the Fifth Circuit Court of Appeals affirmed the decisions of the lower courts, finding that severance payments made to a former CEO prior to the bankruptcy filing were fraudulent transfers.[215] The trustee sought avoidance and recovery of the severance payments pursuant to section 548(a)(1)(B)(ii)(IV), arguing that such payments were constructively fraudulent because they were made to an insider for less than reasonably equivalent value and outside of the ordinary course of business.[216]

In 2000, John Stanley ("Stanley"), the former CEO of TransTexas Gas Corporation, entered into an employment agreement (the "Employment Agreement") that provided for payment to Stanley of (a) $3 million if terminated without cause, (b) $1.5 million if terminated for cause and (c) nothing if he resigned. Early in 2001, the board of directors determined that "cause" existed to terminate Stanley.[217] Stanley and the debtor then negotiated the terms of Stanley's departure and executed a separation agreement that superseded the Employment Agreement and provided that Stanley would receive $3 million in severance payments fol-

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[212]*See* section II.A. of this Article for the relevant language of section 548(a)(1)(B)(ii)(IV).

[213]*In re TransTexas Gas Corp.*, 597 F.3d 298, Bankr. L. Rep. (CCH) P 81684 (5th Cir. 2010).

[214]*In re TSIC, Inc.*, 428 B.R. 103 (Bankr. D. Del. 2010).

[215]In re TransTexas Gas Corp., 597 F.3d at 301–2.

[216]Query whether section 548(a)(1)(B)(ii)(IV) applied to a case filed in 2005 when this portion of BAPCPA only applies to cases commenced after its enactment on April 21, 2005. *See* Pub. L. No. 109-8, § 1406(b)(1) (2005).

[217]In re TransTexas Gas Corp., 597 F.3d at 302.

lowing his resignation in March 2002.[218] In November 2002 the debtor filed for Chapter 11 protection.[219] Stanley received $2,270,794.90 in separation payments prior to the bankruptcy filing.[220]

On appeal, Stanley challenged the district court's finding that he was an insider for purposes of section 548(a)(1) on the basis that he was no longer an employee, and therefore not an insider when the payments were made. The Fifth Circuit rejected this argument, noting that the plain language of the statute made clear that, for purposes of section 548, it was enough that Stanley "was an insider either at the time of the transfer . . . or at the time the company incurred such obligation."[221]

As to the question of whether Stanley had provided reasonably equivalent value in exchange for the severance payments, the Fifth Circuit confirmed that this was a question of fact, subject only to a "clearly erroneous" standard of review.[222] Stanley argued that the severance payments were made in satisfaction of an antecedent debt owed under the Employment Agreement and therefore the payments were for reasonably equivalent value.[223] However, the court held that no antecedent debt existed since (a) "cause" had existed for Stanley's termination and (b) he would not have been entitled to severance under the Employment Agreement, due to his resignation.[224] Thus, the Fifth Circuit found no error in the district court's finding that Stanley did not provide reasonably equivalent value in exchange for the severance payments.[225]

Finally, Stanley challenged the bankruptcy court's determination that the debtor was insolvent at the time of the transfers. However, the Fifth Circuit found that because Stanley was an insider at the time the obligation was incurred, it was unneces-

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[218]In re TransTexas Gas Corp., 597 F.3d at 302.

[219]In re TransTexas Gas Corp., 597 F.3d at 302.

[220]In re TransTexas Gas Corp., 597 F.3d at 302.

[221]In re TransTexas Gas Corp., 597 F.3d at 305.

[222]In re TransTexas Gas Corp., 597 F.3d. at 306 (citing *Matter of Dunham*, 110 F.3d 286, 289, 37 Collier Bankr. Cas. 2d (MB) 1307, Bankr. L. Rep. (CCH) P 77413 (5th Cir. 1997)).

[223]In re TransTexas Gas Corp., 597 F.3d at 307.

[224]In re TransTexas Gas Corp., 597 F.3d at 302.

[225]In re TransTexas Gas Corp., 597 F.3d at 307.

sary to determine solvency,[226] observing that the Bankruptcy Code provides that:

> The language in [s]ection 548 regarding fraudulent transfers is clear that there are different ways in which such transfers can occur. One alternative is that a transfer have [sic] been made when the debtor was insolvent . . . Another alterative is the transfer be made "to or for the benefit of an insider, . . . under an employment contract and not in the ordinary course of business."[227]

2. *In re TSIC, Inc.*

In *TSIC*,[228] the Bankruptcy Court for the District of Delaware examined whether severance payments made to the debtor's former CEO, Richard Thalheimer ("Thalheimer"), were avoidable as constructive fraudulent transfers pursuant to section 548(a)(1)(B)(ii)(IV) of the Bankruptcy Code. Thalheimer had been employed pursuant to a 2002 employment agreement (the "2002 Agreement"), which provided that Thalheimer would receive an unspecified severance package upon termination regardless of cause.[229] Late in 2006, the board voted to terminate Thalheimer and the terms of Thalheimer's severance were negotiated while he was still a member of the board and memorialized in a settlement agreement (the "2006 Agreement").[230] In exchange for the 2006 Agreement, Thalheimer agreed to resign and waive future claims against the debtor.[231] The severance payments were made after Thalheimer left the company and within the two years prior to the debtor's bankruptcy filing in February of 2008.[232]

The bankruptcy court held that the severance payments were avoidable as constructively fraudulent transfers pursuant to section 548(a)(1)(B)(ii)(IV) because they were made for the benefit of an insider and not in the ordinary course of the debtor's business.[233] In reaching this conclusion, the bankruptcy court addressed the issue of whether the debtor received reasonably equivalent value in exchange for the severance payments, and held that Thalheimer's preexisting obligation to serve as CEO in exchange for his salary pursuant to the 2002 Agreement did not

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[226] In re TransTexas Gas Corp., 597 F.3d at 308.

[227] In re TransTexas Gas Corp., 597 F.3d at 308.

[228] *In re TSIC, Inc.*, 428 B.R. 103 (Bankr. D. Del. 2010).

[229] In re TSIC, Inc., 428 B.R. at 108.

[230] In re TSIC, Inc., 428 B.R. at 108.

[231] In re TSIC, Inc., 428 B.R. at 108.

[232] In re TSIC, Inc., 428 B.R. at 108–9.

[233] In re TSIC, Inc., 428 B.R. at 116–17.

constitute reasonably equivalent value.[234] Further, the court found that, at the time of his resignation and waiver of future claims, the debtor was already headed towards bankruptcy and that such waiver and resignation were not beneficial or instrumental to the debtor's success.[235]

Like the former CEO in *TransTexas*,[236] Thalheimer argued that the action was barred by the two year look-back period provided by section 548(a)(1) because the debtor's obligation to make severance payments arose pursuant to the 2002 Agreement.[237] The debtor argued that the obligation to pay severance was incurred pursuant to the 2006 Agreement that was entered into within the two-year statutory period at a time while Thalheimer was still an insider. In addressing this issue, the bankruptcy court noted that the facts of *TransTexas* closely resembled the facts in the *TSIC* case, and ruled that, based upon the *TransTexas* decision and the legislative intent of BAPCPA, the date the agreement was entered into was the proper mark for determining Thalheimer's insider status.[238] "[T]o conclude otherwise would completely undermine the purpose of the 2005 amendment . . . [T]he purpose of the BAPCPA amendments in extending the look-back period was to protect creditors and the assets of the estate from excessive bonuses, loans, and payouts made to corporate insiders outside of the ordinary course of business."[239] The court also observed that:

> Were the date of receiving the payment the date of determining insider status, severance payments such as the one in this case could never be avoided under the statute because insiders would obtain the right to payment but leave the company prior to receipt thus circumventing the purpose of [s]ection 548.[240]

The court rejected Thalheimer's assertion that the severance constituted payment of an antecedent debt made in the ordinary course of business. Citing precedent holding that transfers made for the sole benefit of an insider are not made in the ordinary course, the court noted that Thalheimer's ouster was an extraor-

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[234]In re TSIC, Inc., 428 B.R. at 114–15.

[235]In re TSIC, Inc., 428 B.R. at 114–15.

[236]In re TransTexas Gas Corp., 597 F.3d at 307–8.

[237]In re TSIC, Inc., 428 B.R. at 110–11.

[238]In re TSIC, Inc., 428 B.R. at 113.

[239]In re TSIC, Inc., 428 B.R. at 112–13 (citing 151 Cong. Rec. § 1979-01, 2005 WL 497395, at *21–26 (Cong. Rec. Mar. 3, 2005)).

[240]In re TSIC, Inc., 428 B.R. at 113.

dinary and unique event.[241] The severance payments were clearly outside the ordinary course because (a) the 2006 Agreement granting the payments was not executed until nearly five years after the 2002 Agreement and (b) no other director or officer received severance payments.[242]

Both *TransTexas* and *TSIC* serve as a warning to senior executives of troubled corporations that their severance packages can be avoided as a result of their insider status at the time of execution of any agreements providing for severance. Executives should take note that a defense based upon the argument that they are not insiders at the time the severance is paid will likely fail, since insider status is determined when the obligation to pay severance is incurred. Finally, executives should expect an uphill battle if attempting to assert that prior services provided the reasonably equivalent value required to defeat an action seeking to avoid severance as a constructive fraudulent transfer under section 548(a)(1)(B)(ii)(IV).

D. Limitations on Avoidance Actions under Chapter 15

Last year's Article discussed at length the Southern District of Mississippi's decision in *In re Condor Insurance Ltd.* holding that the bankruptcy court lacked jurisdiction to permit court-appointed liquidators of a foreign debtor to commence an avoidance action in the United States under foreign law in a Chapter 15 case.[243] Since then, the foreign liquidators successfully appealed that decision to the Fifth Circuit which reversed the lower courts' rulings and held that a bankruptcy court has authority to permit a foreign representative[244] to seek relief under foreign

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[241] In re TSIC, Inc., 428 B.R. at 116.

[242] In re TSIC, Inc., 428 B.R. at 116.

[243] *In re Condor Ins. Ltd.*, 411 B.R. 314, 61 Collier Bankr. Cas. 2d (MB) 673 (S.D. Miss. 2009), judgment rev'd, 601 F.3d 319, Bankr. L. Rep. (CCH) P 81712 (5th Cir. 2010) ("*Condor I*"). For an instructive overview of Chapter 15, *see* Dunaway, The Law of Distressed Real Estate § 39A.

[244] When a foreign main proceeding is recognized by a United States Bankruptcy Court, the representative of the foreign debtor, known as the "foreign representative," is vested with some of the powers given to a bankruptcy trustee under the Bankruptcy Code; however, there are certain limitations, as discussed in this section of the Article, that apply to the exercise of these powers. *See* 11 U.S.C.A. § 1521.

avoidance law in a Chapter 15 proceeding, regardless of whether a petition under Chapter 7 or Chapter 11 also has been filed.[245]

At issue in *Condor* was the interplay between two sections of Chapter 15 of the Bankruptcy Code: sections 1523 and 1521(a)(7). Section 1523 provides a foreign representative with standing to initiate certain actions, including an avoidance action commenced under Chapter 5 of the Bankruptcy Code, when brought in a Chapter 7 or Chapter 11 case.[246] Section 1521 is "discretionary in nature" and generally provides that a bankruptcy court may grant "any appropriate relief that is necessary to effectuate the purpose of Chapter 15" and to protect the respective interests of both the debtor's estate and its respective creditors.[247] However, section 1521(a)(7) expressly *excludes* from the bankruptcy court's discretionary relief powers the ability to grant relief under several of the provisions of Chapter 5 of the Bankruptcy Code.[248]

Condor involved the liquidation of an insurance and surety bond corporation, Condor Insurance, Ltd. ("CIL"), which was organized under the laws of Nevis.[249] The court-appointed liquidators (the "Foreign Liquidators") in the Nevis wind-up proceeding alleged that over $313 million in CIL estate assets were fraudulently transferred in "an attempt to prevent creditors from recovering debts owed by CIL in the [wind-up] proceeding."[250] The Foreign Liquidators initiated a Chapter 15 proceeding and obtained recognition from the bankruptcy court of the Nevis liquidation as a "foreign main proceeding."[251] The Foreign Liquidators then filed an adversary proceeding in the Chapter 15 case seeking to recover, under Nevis law, assets that were alleg-

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[245] *In re Condor Ins. Ltd.*, 601 F.3d 319, 329, Bankr. L. Rep. (CCH) P 81712 (5th Cir. 2010) ("*Condor II*").

[246] *See* note 254 for the relevant language of section 1523.

[247] Condor II, at 317.

[248] *See* note 254 for the relevant language of section 1521.

[249] Condor I, 411 B.R. at 316.

[250] Condor I, 411 B.R. at 316.

[251] Condor I, 411 B.R. at 316. A "foreign main proceeding" is defined in the Bankruptcy Code as "a foreign proceeding pending in the country where the debtor has the center of its main interests." 11 U.S.C.A. § 1502. When a proceeding is recognized as a "foreign main proceeding," certain Bankruptcy Code provisions automatically go into effect, while other provisions may only be utilized at the discretion of the presiding bankruptcy court. One important right granted to a foreign representative after a proceeding is recognized as a "foreign main proceeding" is the ability to file a bankruptcy case under Chapters 7 or 11 of the Bankruptcy Code.

edly fraudulently transferred to parties located in the United States (the "Foreign Law Avoidance Action").[252]

As foreign insurance companies are prohibited from filing petitions under Chapter 7 or Chapter 11 pursuant to section 109 of the Bankruptcy Code,[253] the Foreign Liquidators were compelled to craft an argument that would allow them to navigate around the limitations of sections 1521 and 1523 on granting relief under Chapter 5 of the Bankruptcy Code.[254] The Foreign Liquidators maintained that a plain reading of sections 1521 and 1523 demonstrated that they were "only prohibited from utilizing certain sections of the Bankruptcy Code when seeking avoidance and [were] not prohibited from seeking such relief under applicable foreign law."[255] Thus, while the Foreign Liquidators were not able to take advantage of the causes of action provided under Chapter 5 of the Bankruptcy Code, they argued that they were not prohibited from seeking to avoid transfer using foreign law.[256] The district court disagreed, noting that the "plain language of the statutes does not specifically address the use of avoidance powers under foreign law."[257] Looking to legislative history,[258] the district court had held:

> [s]ection 1521(a)(7) and [s]ection 1523 are intended to exclude all of the avoidance powers specified, under either United States *or*

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[252]Condor I, 411 B.R. at 316.

[253]*See* 11 U.S.C.A. §§ 109(b)(3)(A) & 109(d). *See also Condor II*, 601 F.3d at 321.

[254]Section 1521 provides in relevant part:

> (a) Upon recognition of a foreign proceeding, whether main or nonmain, where necessary to effectuate the purpose of this chapter and to protect the assets of the debtor or the interest of the creditors, the court may, at the request of the foreign representative, grant any appropriate relief, including -
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> (7) granting any additional relief that may be available to a trustee, except for relief available under sections 522, 544, 545, 547, 548, 550, and 724(a).

11 U.S.C.A. § 1521(a).

Section 1523 provides in relevant part:

> (a) Upon recognition of a foreign proceeding, the foreign representative has standing in a case concerning the debtor pending under another chapter of this title to initiate actions under sections 522, 544, 545, 547, 548, 550, 553, and 724(a).

11 U.S.C.A. § 1523(a).

[255]Condor I, 601 F.3d at 317.

[256]Condor I, 601 F.3d at 317–18.

[257]Condor I, 601 F.3d at 318.

[258]Condor I, 601 F.3d at 317–19.

> *foreign law*, unless a Chapter 7 or 11 bankruptcy proceeding is instituted. The legislative history supports this statutory interpretation. Congress defers to courts regarding proper choice of law and forum and requires foreign representatives to file a full bankruptcy case, so that these decisions can be made.[259]

Since the foreign representatives had only filed a Chapter 15 case, the district court found the bankruptcy court lacked subject matter jurisdiction to adjudicate such an avoidance action absent the commencement of a case under Chapter 7 or 11.[260]

On appeal to the Fifth Circuit, the Foreign Liquidators requested review of the issue of whether a foreign representative could commence an avoidance action under foreign law in a Chapter 15 case, notwithstanding the limitations of sections 1521(a)(7) and 1523 of the Bankruptcy Code.[261] The Fifth Circuit held that foreign representatives were not required to file a petition under Chapter 7 or Chapter 11 in order to commence avoidance actions based upon avoidance laws of a foreign jurisdiction.[262]

1. The Fifth Circuit's Interpretation of Chapter 15

The Fifth Circuit's opinion was directed primarily at correcting the lower courts' erroneous interpretation of the history and purpose behind Chapter 15. The court observed that, when a foreign main proceeding is recognized by a bankruptcy court, the representative of the foreign debtor, known as the "foreign representative," is vested with some of the powers given to a bankruptcy trustee under the Bankruptcy Code, but there are certain limitations that apply to the exercise of these powers.[263] In interpreting the scope of these limitations, the Fifth Circuit instructed that the overriding purpose of Chapter 15 is to "further cooperation between the U.S. courts, parties in U.S. bankruptcy proceedings and foreign insolvency courts and authorities, as well as promote 'greater legal certainty', 'fair and efficient

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[259]Condor I, 601 F.3d at 319 (emphasis added); *but see* In re Atlas Shipping, 404 B.R. at 744 (stating in *dicta* that *Condor I's* "conclusion that Congress intended to prevent a foreign representative from bringing avoidance actions based on foreign law is not supported by anything specifically in the legislative history").

[260]Condor I, 411 B.R. at 319.

[261]Condor II, 601 F.3d at 329.

[262]Condor II, 601 F.3d at 329.

[263]Condor II, 601 F.3d at 324–26. *See also* 11 U.S.C.A. § 1521.

administration of cross-border insolvencies that protects the interests of all creditors.' "[264]

In particular, the court disagreed with the district court's failure to read the plain language of sections 1521 and 1523 of the Bankruptcy Code and its interpretation of the legislative history of those sections when ruling that these sections were intended to exclude all of the avoidance powers unless a Chapter 7 or 11 bankruptcy proceeding is instituted.[265] The Fifth Circuit observed that while section 1521 denies a foreign representative the powers of avoidance under the Bankruptcy Code absent a Chapter 7 or 11 filing, the plain language of section 1521 did not demonstrate that "Congress intended to deny the foreign representative powers of avoidance supplied by applicable foreign law."[266]

The Fifth Circuit found that "Congress did not intend to restrict the powers of the U.S. court to apply the law of the country where the main proceeding pends," noting that it would result in numerous debtors hiding assets in the United States, putting them out of reach of foreign jurisdiction, thereby forcing foreign representatives to "initiate much more expansive proceedings to recover assets fraudulently conveyed, the scenario Chapter 15 was designed to prevent."[267] The court was not persuaded that Congress would have "unwittingly facilitated such tactics with foreign insurance companies, [as] access to Chapters 7 and 11 is otherwise denied [to them],"[268] and concluded that if "Congress wished to bar all avoidance actions whatever their source, it could have stated so."[269]

The Fifth Circuit also found that the district court's holding was contrary to the origins of Chapter 15, which was modeled on the UNCITRAL Model Law on Cross-Border Insolvency.[270] The court noted that the primary purpose of Chapter 15 was to help

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[264]Condor II, 601 F.3d at 324 (quoting 11 U.S.C.A. § 1501).

[265]Condor I, 411 B.R. at 319.

[266]Condor II, 601 F.3d at 324. The Fifth Circuit was not alone in its criticism of the district court's holding, as a decision out of the Bankruptcy Court for the Southern District of New York noted in *dicta* that *Condor I's* holding that "[c]ongress intended to prevent a foreign representative from bringing avoidance actions based on foreign law is not supported by anything specifically in the legislative history." In re Atlas Shipping, 404 B.R. at 744.

[267]Condor II, 601 F.3d at 327.

[268]Condor II, 601 F.3d at 327.

[269]Condor II, 601 F.3d at 324.

[270]The United Nations Commission on International Trade Law Model Law on Cross-border Insolvency ("UNCITRAL") represented an effort by the United

harmonize cross-border insolvency proceedings.[271] While Chapter 15 of the Bankruptcy Code did not specifically mention the use of foreign avoidance law in a Chapter 15 proceeding, the court found it should be broadly interpreted as such to allow a bankruptcy court to grant that power in order to promote comity with foreign jurisdictions.[272] The Fifth Circuit concluded that "[t]hough the language [of Chapter 15] does not explicitly address the use of foreign avoidance law, it suggests a broad reading of the powers granted to the district court in order to advance the goals of comity to foreign jurisdiction."[273] Thus, the Fifth Circuit confirmed that the ability to commence avoidance actions in a Chapter 15 proceeding is not exclusive to foreign representatives who also have filed a Chapter 7 or 11 proceeding.

The Fifth Circuit found further support for its ruling by looking to earlier decisions that interpreted former section 304 of the Bankruptcy Code, the predecessor to Chapter 15.[274] The court noted that the legislative history of Chapter 15 made clear that "Congress intended that case law under section 304 apply unless

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States and other countries to develop a uniform system to help guide cross-border insolvency.

[271]Condor II, 601 F.3d at 321–22. *See also In re JSC BTA Bank*, 434 B.R. 334, 340, 63 Collier Bankr. Cas. 2d (MB) 1711 (Bankr. S.D. N.Y. 2010) (noting that the overriding purpose of Chapter 15 is to promote cooperation between United States courts and foreign insolvency courts).

[272]Condor II, 601 F.3d at 325.

[273]Condor II, 601 F.3d at 325.

[274]Section 304 of the Bankruptcy Code provided in relevant part:

(b) . . . the court may-

(1) enjoin the commencement or continuation of-

(A) any action against- (i) a debtor with respect to property involved in such foreign proceeding; or (ii) such property; or (B) the enforcement of any judgment against the debtor with respect to such property, or any act or the commencement or continuation of any judicial proceeding to create or enforce a lien against the property of such estate;

(2) order turnover of the property of such estate, or the proceeds of such property, to such foreign representative; or

(3) order other appropriate relief.

11 U.S.C.A. § 304(b) (2000), *repealed by* BAPCPA § 802(d)(3), 119 Stat. at 146. Other courts have found former section 304 of the Bankruptcy Code helpful when interpreting Chapter 15. *See In re International Banking Corp. B.S.C.*, 439 B.R. 614, 624 (Bankr. S.D. N.Y. 2010) (noting that courts should read Chapter 15 consistently with prior law under section 304 of the Bankruptcy Code) (citing In re Atlas Shipping A/S, 404 B.R. at 738–39).

contradicted by Chapter 15."[275] The court observed that although section 304 was more limited in its scope than Chapter 15, it did provide significant discretionary relief such as authorizing a bankruptcy court to order the turnover of property to a foreign representative or apply other appropriate relief.[276] Moreover, courts had previously relied upon this reasoning to interpret section 304 as permitting avoidance actions that relied upon foreign law to continue without requiring the foreign representative to file a Chapter 7 or 11 case.[277] The Fifth Circuit accordingly found that section 304 supported its position that "courts should exercise discretion in the spirit of comity and in the interests of the parties."[278]

Condor II represents an initial judicial interpretation at an appellate level of the breadth of the limitations on a foreign representative under sections 1521(a)(7) and 1523 of the Bankruptcy Code to commence an avoidance action in a Chapter 15 case under foreign law. Significantly, *Condor II* is unambiguous in its holding that a foreign representative may bring an avoidance action under foreign law in a Chapter 15 proceeding without having to file a Chapter 7 or 11 case. While the Fifth Circuit's decision is logical and consistent with case law prior to the enactment of Chapter 15 and the purposes of Chapter 15, it remains to be

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[275]Condor II, 601 F.3d at 328 (citing H.R. Rep. 109–31, 109th Cong., 1st Sess., 2005 U.S.C.C.A.N. 88 (2005)).

[276]Condor II, 601 F.3d at 328 "Other appropriate relief" granted under former section 304 included the appointment of an independent co-trustee and allowing a request for discovery to proceed. *See In re Gee*, 53 B.R. 891, 905, 13 Bankr. Ct. Dec. (CRR) 757, Bankr. L. Rep. (CCH) P 70824 (Bankr. S.D. N.Y. 1985) (holding that section 304(b)(3) allowed the bankruptcy court to direct that discovery be allowed to proceed); *In re Lineas Areas de Nicaragua, S. A.*, 13 B.R. 779, 780, 7 Bankr. Ct. Dec. (CRR) 1371, 4 Collier Bankr. Cas. 2d (MB) 1523 (Bankr. S.D. Fla. 1981) (concluding that section 304(b)(3) gives the bankruptcy court authority to "appoint a co-trustee whose authority and responsibility does not extend beyond the debtor's assets and affairs in this country").

[277]Condor II, 601 F.3d at 328 (citing *In re Metzeler*, 78 B.R. 674, 677, 16 Bankr. Ct. Dec. (CRR) 662, 17 Collier Bankr. Cas. 2d (MB) 812, Bankr. L. Rep. (CCH) P 72023 (Bankr. S.D. N.Y. 1987) (the court held that section 304's purpose is to assist implementation of the foreign court's decrees and "not to provide the foreign representative with the benefit of American avoidance powers")); *see also Petition of Kojima*, 177 B.R. 696, 703 n.35, 26 Bankr. Ct. Dec. (CRR) 881, 33 Collier Bankr. Cas. 2d (MB) 529, Bankr. L. Rep. (CCH) P 76418 (Bankr. D. Colo. 1995) (allowing an avoidance action under Japanese law to proceed pursuant to section 304).

[278]Condor II, 601 F.3d at 328.

seen whether other courts will be as expansive in their interpretation of sections 1521(a)(7) and 1523.[279]

E. Securitized Investment Pool Trustee Liable as Initial Transferee of Fraudulent Transfers

As noted in section II.B. of this Article, as a general rule, pursuant to section 550(a) of the Bankruptcy Code, a "mere conduit" of transferred funds, without any control over the funds' ultimate disposition, is not liable for recovery in a fraudulent transfer action commenced under the Bankruptcy Code. In *Paloian*, the United States Court of Appeals for the Seventh Circuit recently considered this rule when it vacated the decisions of the bankruptcy[280] and district courts,[281] and ruled that a bank acting as trustee for holders of certificates of a securitized trust was an "initial transferee" of certain payments on the certificates and was therefore the appropriate subject of an avoidance action to recover those sums.[282] Although this was an issue of first impression for federal appellate courts, the Seventh Circuit's decision in *Paloian* suggests that trustees with mere legal title to funds transferred by a debtor can be liable in avoidance actions, regardless of whether the trustee has any discretion over disposition of the funds under the terms of the relevant agreements.[283] While the Seventh Circuit stopped short of finding that the payments at issue were fraudulent transfers, instead remanding to the bankruptcy court for additional fact-finding on related issues, the decision opens the door for avoidance actions against trustees to securitized vehicles and from assets of trusts or similar entities.

In *Paloian*, Doctors Hospital of Hyde Park, in Chicago (the "Hospital"), took out two loans in the three years prior to its bankruptcy filing in August 2000, certain payments on which the Hospital's trustee in bankruptcy eventually sought to recover as fraudulent transfers.[284] The first loan was a $25 million line of credit extended in March 1997 by Daiwa Healthco ("Daiwa") to

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[279] As mentioned in note 274, a recent case from the Bankruptcy Court for the Southern District of New York, *In re Int'l Banking Corp. B.S.C.*, has favorably cited *Condor II*'s holding that a bankruptcy court has the authority under Chapter 15 of the Bankruptcy Code to decide an avoidance claim based on foreign law. In re Int'l Banking Corp. B.S.C., 439 B.R. at 629.

[280] 360 B.R. 787 (Bankr. N.D. Ill. 2007).

[281] 406 B.R. 229 (N.D. Ill. 2009).

[282] Paloian, 619 F.3d at 692–96.

[283] Paloian, 619 F.3d at 691–93.

[284] Paloian, 619 F.3d at 690–91.

MMA Funding, L.L.C. ("MMA"), a non-debtor entity owned by a controlling shareholder of the Hospital.[285] MMA was intended to be bankruptcy-remote so that Daiwa could be assured of repayment.[286] As part of the transaction, the Hospital purportedly transferred all of its current and future accounts receivable to MMA, and Daiwa took a security interest in the accounts.[287] In August 1997, Nomura Asset Capital Corporation ("Nomura") loaned $50 million to the Hospital through HPCH LLC ("HPCH"), a non-debtor affiliate of the Hospital that owned its building and land.[288] HPCH made funds available to the Hospital in exchange, in part, for additional rent. Nomura was then granted a security interest in the additional rent.[289] The Nomura loan was sold shortly thereafter to a third party who packaged it with millions of dollars of commercial credit and securitized it for resale to investors.[290] The notes and accompanying security interests were transferred to a trust, of which LaSalle National Bank ("LaSalle") was trustee.[291] Some of the payments to LaSalle on the Nomura loan were made by MMA, rather than the Hospital.[292]

The bankruptcy and district courts agreed that the increased rent payments to HPCH were more properly characterized as debt service by the Hospital on the Nomura loan, and recoverable from LaSalle as fraudulent transfers because the Hospital had been insolvent when the Nomura loan was made in August 2007.[293] The lower courts limited the Hospital's recovery, however, by concluding that any payments on the Nomura loan made by MMA were outside of bankruptcy because they were made with MMA's assets and not the Hospital's.[294] On appeal, the Seventh Circuit considered three questions: (1) whether LaSalle was an "initial transferee" subject to liability in a fraudulent transfer action; (2) whether the Hospital was insolvent when the Nomura loan was made; and (3) whether the Hospital's accounts receiv-

[285]Paloian, 619 F.3d at 690.

[286]Paloian, 619 F.3d at 690.

[287]Paloian, 619 F.3d at 690.

[288]Paloian, 619 F.3d at 690.

[289]Paloian, 619 F.3d at 690.

[290]Paloian, 619 F.3d at 690.

[291]Paloian, 619 F.3d at 690.

[292]Paloian, 619 F.3d at 691.

[293]Paloian, 619 F.3d at 690–91.

[294]Paloian, 619 F.3d at 691.

able had been sold to MMA or if they remained assets of the Hospital that could be pursued in a fraudulent transfer suit.

1. Liability of Trustee to Securitized Trustee

A key legal issue addressed by the Seventh Circuit in *Paloian* was whether the bankruptcy trustee could seek to recover payments by the Hospital to LaSalle, based on the assertion that LaSalle was an "initial transferee" of the payments for purposes of section 550(a)(1) of the Bankruptcy Code. Section 550(a)(1) provides that avoidable transfers may be recovered from initial transferees, recipients from initial transferees, and any entity for whose benefit the transfers were made.[295] Although the Bankruptcy Code does not define the term "initial transferee," courts considering the issue regularly hold that a transferee must have some control over the funds to be held liable in an avoidance action.[296] LaSalle argued that it was a "mere conduit" and compared itself to a bank holding money in a checking account for a customer, claiming that it was simply a conduit for the funds, which were placed into trust for the benefit of the investors and distributed by the trustee pursuant to the parties' trust agreement.[297]

With Chief Judge Easterbrook writing for the panel, the Seventh Circuit found that LaSalle was the initial transferee for purposes of section 550(a) of the Bankruptcy Code, but vacated the orders of the lower courts and remanded the case back to the bankruptcy court for additional findings of fact on the issues of solvency and whether MMA was truly bankruptcy-remote.[298] While the Seventh Circuit recognized that the Bankruptcy Code does not define "initial transferee," it rejected LaSalle's reading

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[295]The language of section 550(a)(1) is provided in section II.B. of this Article.

[296]*See In re Antex, Inc.*, 397 B.R. 168, 172–73, 50 Bankr. Ct. Dec. (CRR) 266, 61 Collier Bankr. Cas. 2d (MB) 15 (B.A.P. 1st Cir. 2008) (holding that "it is widely accepted that a transferee is one who at least has dominion over the money or other asset, the right to put the money to one's own purposes") (quotations omitted); *In re CVEO Corp.*, 327 B.R. 210, 217, 45 Bankr. Ct. Dec. (CRR) 30 (Bankr. D. Del. 2005) (holding that having dominion and control over funds means to be able to use the funds for whatever purpose he or she wishes, "be it to invest in lottery tickets or uranium stocks") (quotations omitted).

[297]LaSalle, for reasons not specified in its briefs, did not raise the argument that it was a good faith transferee for value under section 550(b)(1) of the Bankruptcy Code. Paloian, 619 F.3d at 691.

[298]Paloian, 619 F.3d at 695–96. If the bankruptcy court finds that the debtor was insolvent when any of the transfers on the Nomura loan subsequent to August 1997 were made, given the holding on the "initial transferee" issue, LaSalle could be liable for the fraudulent transfer.

of, and indeed relied upon its own earlier decision in, *Bonded Financial Services, Inc., v. European American Bank*,[299] to conclude that LaSalle was the "initial transferee" since it was the legal owner of the trust's assets. The Seventh Circuit found that:

> . . . *Bonded Financial Services* adopted an approach that tracks the function of the bankruptcy trustee's avoiding powers: to recoup money from the real recipient of [avoided] transfers. In *Bonded Financial Services*, that recipient was the bank's customer, who had full control over the balance in the checking account [used to transfer to the fraudulently transferred funds]. In this situation, the real recipient is LaSalle Bank, which is the trustee of the securities pool. In American law, a trustee is the legal owner of the trust's assets . . . Although LaSalle Bank has duties to the trust's beneficiaries (the investors) concerning the application of funds, the assets' owner remains the appropriate subject of a preference-avoidance action. If LaSalle Bank must hand $10 million over to the bankruptcy estate, it will draw that money from the corpus of the trust, not from the Bank's corporate assets. This means that the money really comes from the trust's investors—the persons 'for whose benefit [the] transfer was made.' . . . lots of decisions hold that an entity that receives funds for use in paying down a loan, or passing money to investors in a pool, is an "initial transferee" even though the recipient is obliged by contract to apply the funds according to a formula . . . All of these courts say that they are adopting and applying the approach that this circuit devised in *Bonded Financial Services*. We agree with that assessment . . .[300]

Thus, since the purpose of a trustee's avoiding powers is to "recoup money from the real recipient" of the transfers, the Seventh Circuit held that the "real recipient" was LaSalle because under "American law," a trustee is the legal owner of a trust's assets, notwithstanding the trustee's duties to the trust's beneficiaries.[301]

Treating the issue seemingly as one of pragmatics, the Seventh Circuit found it would be efficient for the bankruptcy trustee to seek recourse from a trustee, who could draw funds from the corpus of the trust "[i]nstead of requiring the bankruptcy trustee to sue thousands of investors who may have received interest payments that were increased, slightly, by the money from the

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[299] *Bonded Financial Services, Inc. v. European American Bank*, 838 F.2d 890, 17 Bankr. Ct. Dec. (CRR) 299, 18 Collier Bankr. Cas. 2d (MB) 155 (7th Cir. 1988).

[300] Paloian, 619 F.3d at 691–92.

[301] Paloian, 619 F.3d at 691–92.

Hospital's coffers, a single lawsuit suffices . . .."[302] In reaching its decision, the court did not further analyze the scope of the trustee's discretion under the securitization trust agreement or the broader implications of its decision.

2. Solvency Analysis

A threshold question for a constructive fraudulent transfer analysis is whether the transferor was either insolvent at the time of the challenged transfer or was rendered insolvent as a result of the transfer.[303] The bankruptcy court had concluded that the Hospital was insolvent in August 1997 despite the fact that it had positive financial statements and was current in paying its creditors.[304] The Seventh Circuit rejected the bankruptcy court's solvency finding as flawed for several "glaring" reasons, reversed its determination, and remanded the question of whether the Hospital became insolvent at some point between August 1997 and its bankruptcy filing in April 2000.[305] If the bankruptcy court were to later find the Hospital was solvent at the time of the challenged transfers, the claims against the LaSalle would fail regardless of the other rulings made below and by the Seventh Circuit.

3. Sale to "Bankruptcy-Remote" Vehicle

Finally, the court evaluated whether MMA was a legitimate bankruptcy-remote vehicle that had purchased the Hospital's accounts receivable in a true sale.[306] If it was not, then payments made through that entity to LaSalle while the Hospital was insolvent would be subject to recapture. The Seventh Circuit noted that, in order for an entity to be considered a bankruptcy-remote vehicle, it must among other things observe corporate formalities, be a separate entity, and "structure their transactions so that their economic substance lies outside particular sections of the Bankruptcy Code."[307] Although the Seventh Circuit remanded this issue to the bankruptcy court for further fact-finding, if necessary, after first determining the threshold issue of solvency, it observed that MMA's apparent complete disregard

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[302]Paloian, 619 F.3d. at 692.

[303]This is true except when payments are made to or obligations are incurred for the benefit of insiders, as discussed in section III.C. of this Article.

[304]Paloian, 619 F.3d at 692–93.

[305]Paloian, 619 F.3d at 693–95.

[306]Paloian, 619 F.3d at 695–96.

[307]Paloian, 619 F.3d at 695.

for corporate formalities and the fact that the Hospital continued to carry the accounts receivable on its own books as a corporate asset was "the sort of structure that makes the payments amenable to a . . . recovery action whether or not the receivables are remitted to a lockbox at a bank."[308] The court noted that the "MMA Funding lacked the usual attributes of a bankruptcy-remote vehicle," thus casting doubt on whether MMA would be viewed as bankruptcy-remote upon remand to the bankruptcy court.[309]

The Seventh Circuit's conclusion that a trustee to a securitized trust may be an "initial transferee" for purposes of section 550(a) has important implications for entities serving in similar trustee roles, as well as for investors in "bankruptcy-remote" products. While the Seventh Circuit concluded that LaSalle, as trustee, could make any required payments to a bankruptcy estate from the corpus of the trust, presumably without damage to itself, it did not address what would happen (a) if there was no such corpus and the trustee was obligated to make payments from its own funds and seek reimbursement from what could be thousands of investors; (b) if the trust beneficiaries had changed since the transfers were made; or (c) if the trust had terminated or expired. Indeed, the decision seems to ignore that trustees to securitized trusts are typically contractually bound to transfer funds to the trust investors and have no beneficial interest in such funds.

It remains to be seen whether courts in other circuits will adopt this reasoning or whether courts will consider the scope of a trustee's authority and discretion in greater detail when determining initial transferee status. In the meantime, the potential impact of the *Paloian* decision is considerable. If the trustee of a securitized pool is an "initial transferee," that trustee cannot avail itself of the good-faith defense afforded by section 550(b)—a defense to recovery that only is available to a good-faith transferee other than the "initial transferee" or an "entity for whose benefit [the fraudulent] transfer was made."[310] Also, because the Seventh Circuit recognized that the trust's investors are "the persons for whose benefit" the transfers are made, those investors might similarly be unable to avail themselves of the

[308]Paloian, 619 F.3d at 696.

[309]Paloian, 619 F.3d at 695–96.

[310]11 U.S.C.A. § 550(b).

section 550(b) good-faith defense.[311] Certainly investors should conduct a diligent inquiry into the measures taken to ensure that their investments are (a) shielded by structures that are indeed "bankruptcy-remote" and (b), where possible, covered by the safe-harbor provided by section 546(e) of the Bankruptcy Code.

IV. Summary

A number of trends may be predicted based upon the recent decisions discussed above. It is likely that, in the future, section 548(c)'s "good faith" defense will be the subject of litigation in Ponzi scheme bankruptcy cases and SIPA proceedings, making it challenging for a debtor or trustee to succeed on a motion for summary judgment when a good faith defense is raised. If asserted in the Ponzi scheme context, the section 546(e) safe harbor provision may not provide a defense to a fraudulent transfer action in situations where the safe harbor might otherwise apply. Additionally, while bankruptcy courts are addressing the applicability of heightened pleading standards to fraudulent transfer actions, it appears that the standards are not always evenly applied. Due to the Fifth Circuit's decision in *Condor*, the ability to bring avoidance actions based upon foreign law in a Chapter 15 seems possible, thus broadening the potential scope of Chapter 15.

The cases discussed also provide cautionary tales for both corporate executives and trustees of securitized pools. Importantly, corporate executives may be forewarned that severance packages may be treated as constructively fraudulent transfers. Finally, trustees of a securitized pool of assets should be aware of their potential fraudulent transfer liability as initial transferees under section 550(a) of the Bankruptcy Code.

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[311] Given the nature of their interests, investors may be shielded by the safe harbor of section 546(e). 11 U.S.C.A. § 546(e).