

## 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,<sup>1</sup> sections 548 and 550, respectively. This article first provides an introductory discussion of these provisions,<sup>2</sup> and then discusses certain of the cases decided in 2011 that clarified or otherwise relied on these or similar provisions.

Similar to recent years, as bankruptcy cases filed in the wake of the disruption to the financial markets commencing in 2007 moved toward their conclusions, litigation of avoidance actions ensued, causing 2011 to be another robust year for fraudulent transfer decisions under the Bankruptcy Code. Significantly, in one of three pending appeals from the bankruptcy court's decision (a) avoiding over \$500 million in liens and upstream guarantees granted by the subsidiaries of TOUSA, Inc. to secure a prepetition financing transaction and (b) ordering the disgorgement of proceeds, the United States District Court for the Southern District of Florida reversed and quashed the portion of the bankruptcy court's decision finding lack of reasonably equivalent value for the liens granted by subsidiaries and related

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<sup>1</sup>Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as amended at 11 U.S.C. §§ 101 to 1532 (2011) (the "Bankruptcy Code").

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

transactions, and requiring the disgorgement of proceeds.<sup>3</sup> On the eve of publication of this article, however, the United States Court of Appeals for the Eleventh Circuit Court of Appeals reversed the district court's decision and affirmed the bankruptcy court's controversial decision.<sup>4</sup> Other decisions of note from 2011 resolve disputes about the applicable standards for the good faith defenses under sections 548(c) and 550(b) of the Bankruptcy Code,<sup>5</sup> the requirements for reliance on the "mere conduit" exception to liability under section 550(a) of the Bankruptcy Code,<sup>6</sup> and the related issue of determining who can be an "initial transferee" for purposes of section 550(a) of the Bankruptcy Code.<sup>7</sup> Ponzi scheme cases were once again the source of decisions addressing the issues of reasonably equivalent value, the standards for examining the "good faith" defense of section 548(c) of the Bankruptcy Code, and the applicability of the safe harbor

<sup>3</sup>*In re TOUSA, Inc.*, 422 B.R. 783 (Bankr. S.D. Fla. 2009). *TOUSA I* was discussed at length in the 2010 edition of this article. See Lara R. Sheikh, Section 548 and 550—Developments in the Law on Fraudulent Transfers and Recoveries, Norton Annual Survey of Bankruptcy Law 295 (2010 ed.). Briefly, in *TOUSA II*, the United States District Court for the Southern District of Florida, (citing the 2010 edition of this article), held that (i) settlement payments to the Transeastern Lenders (defined herein) 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. Importantly, the decision in *TOUSA I*, which was recently affirmed by the Eleventh Circuit Court of Appeals, 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. See, e.g., *In re Schaefer*, 2009 WL 3367389, \*2–3 (Bankr. S.D. Ill. 2009) (bankruptcy court adopted reasoning similar to *TOUSA I* to invalidate a mortgage granted by the debtor principals of a non-debtor corporation to secure a note of the non-debtor corporation).

<sup>4</sup>See *In re TOUSA, Inc.*, 680 F.3d 1298, 56 Bankr. Ct. Dec. (CRR) 135 (11th Cir. 2012) ("*TOUSA III*").

<sup>5</sup>See, e.g., *In re Nieves*, 648 F.3d 232, 65 Collier Bankr. Cas. 2d (MB) 1442, Bankr. L. Rep. (CCH) P 82024 (4th Cir. 2011).

<sup>6</sup>See, e.g., *In re Harwell*, 628 F.3d 1312, 54 Bankr. Ct. Dec. (CRR) 12, 64 Collier Bankr. Cas. 2d (MB) 1820, Bankr. L. Rep. (CCH) P 81909 (11th Cir. 2010); *In re Brooke Corp.*, 458 B.R. 579, 55 Bankr. Ct. Dec. (CRR) 154 (Bankr. D. Kan. 2011); *In re Lambertson Truex, LLC*, 458 B.R. 155, 55 Bankr. Ct. Dec. (CRR) 148 (Bankr. D. Del. 2011); *In re Bower*, 462 B.R. 347, Bankr. L. Rep. (CCH) P 82143 (Bankr. D. Mass. 2012).

<sup>7</sup>*In re Harwell*, 628 F.3d 1312, 54 Bankr. Ct. Dec. (CRR) 12, 64 Collier Bankr. Cas. 2d (MB) 1820, Bankr. L. Rep. (CCH) P 81909 (11th Cir. 2010).

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from avoidance included in section 546 of the Bankruptcy Code.<sup>8</sup> These and other important 2011 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 twenty years. However, 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 1998 in its structure as a result of the enactment of the Religious Liberty and Charitable Donation Protection Act of 1998 (the "Charitable Donation Act"),<sup>9</sup> and again in 2005 as a result of the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA").<sup>10</sup>

As further discussed below, section 550, which sets forth the trustee's or debtor-in-possession's power to recover the value of avoided transfers, also was significantly amended under the Bankruptcy Amendments and Federal Judgeship Act of 1984 (the "1984 Amendments"),<sup>11</sup> the Bankruptcy Reform Act of 1994 (the "1994 Reform Act")<sup>12</sup> and BAPCPA.

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<sup>8</sup>See, e.g., *Perkins v. Haines*, 661 F.3d 623, 55 Bankr. Ct. Dec. (CRR) 166, Bankr. L. Rep. (CCH) P 82094 (11th Cir. 2011); *Picard v. Katz*, 462 B.R. 447, 55 Bankr. Ct. Dec. (CRR) 133, Bankr. L. Rep. (CCH) P 82077 (S.D. N.Y. 2011), motion to certify appeal denied, 466 B.R. 208, 55 Bankr. Ct. Dec. (CRR) 266 (S.D. N.Y. 2012); *In re Bernard L. Madoff Inv. Securities LLC*, 2011 WL 3897970 (S.D. N.Y. 2011); *In re Dreier LLP*, 452 B.R. 391 (Bankr. S.D. N.Y. 2011).

<sup>9</sup>Pub. L. No. 105-183, 112 Stat. 517 (1998), codified at 11 U.S.C. § 548(a)(2). For an in-depth discussion of the Charitable Donation Act, see Hiren Patel, Section 548—Recent Developments in the Law of Fraudulent Transfers, Norton Annual Survey of Bankruptcy Law at 527 (1998 ed.).

<sup>10</sup>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 § 548 and BAPCPA § 1501(b)(1) were generally effective immediately.

<sup>11</sup>Pub. L. No. 98-353, 98 Stat. 333 (1984).

<sup>12</sup>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)).

## A. History and Construction of Section 548

Section 548 is derived in large part from section 67(d) of the Bankruptcy Act of 1898.<sup>13</sup> 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)<sup>14</sup> 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:

(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

(B) (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(ii) (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;<sup>15</sup>

(II) was engaged in business or a transaction, or was about

<sup>13</sup>30 Stat. 544 (July 1, 1898) (as amended and as subsequently repealed by the Bankruptcy Code, the "Bankruptcy Act"); see S. Rep. No. 989, 95th Cong., 2nd Sess. (1978), as reprinted in 1978 U.S.C.C.A.N. 5787.

<sup>14</sup>Due to 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, the "reasonably equivalent value" provision in the present section 548(a)(1)(B)(i) was contained in section 548(a)(2)(A) prior to the revisions.

<sup>15</sup>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; see also *In re Worldcom, Inc.*, 357 B.R. 223, 230 (S.D. N.Y.

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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.<sup>16</sup>

The first change relates to changes discussed below with respect to employment contracts as a fourth subtest for reasonably equivalent exchange. As “transfer” is already broadly defined in the Bankruptcy Code,<sup>17</sup> 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

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2006) (grant of debtors' summary judgment motion upheld where evidence of insolvency was so great that insolvency was decided as a matter of law).

<sup>16</sup>In addition to direct changes, BAPCPA also changed other Bankruptcy and 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. § 1409(a). While this section has been referred to by some as the preference venue statute, it should apply to fraudulent transfer recovery actions as well. Generally, unless de minimis, all such actions may be brought where the bankruptcy case itself is venued. For de minimis actions, however, 28 U.S.C. § 1409(a) dictates that such cases may be brought only in the district in which the defendant resides.

BAPCPA also adjusted the thresholds for such de minimis 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.” Post-BAPCPA and after several annual adjustments, the current threshold for property or money judgments is \$1,175, the threshold for consumer debts is \$17,575 and the threshold, added by BAPCPA, for debts (excluding consumer debts) against non-insiders is \$11,725. Actions seeking to avoid smaller amounts as fraudulent transfers must be brought in the district where the defendant resides. 11 U.S.C. § 1409(b).

<sup>17</sup>11 U.S.C. § 101(54); *see In re Bernard*, 96 F.3d 1279, 1282, 36 Collier Bankr. Cas. 2d (MB) 1585 (9th Cir. 1996) (“[A] transfer is a disposition of an interest in property. The definition is as broad as possible . . . Under this definition, any transfer of an interest in property is a transfer, including a transfer of possession, custody or control even if there is no transfer to title, because possession, custody and control are interests in property.”) (quoting S.Rep. No. 95-989 (1978)). *See generally* 2 Collier on Bankruptcy ¶ 101.54 (Alan N. Resnick and Henry J. Sommer eds., 16th ed. 2012).

other than communicate that Congress understands there is a perceived problem in this realm (something that could have been easily communicated in the legislative history to BAPCPA).

The second change altered the look-back period in section 548 from one to two years.<sup>18</sup> 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].”<sup>19</sup> The two-year limitation in this section is augmented by the operation of section 546(a) of the Bankruptcy Code<sup>20</sup> and section 544(b)(1) of the Bankruptcy Code,<sup>21</sup> the latter of which allows the trustee to bootstrap into

<sup>18</sup>See 11 U.S.C. § 548(a)(1), (b).

<sup>19</sup>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). Since BAPCPA was signed into law in April 20, 2005, the change to the look-back period is applicable to cases commenced on or after April 20, 2006.

<sup>20</sup>Section 546(a) 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—
  - (1) the later of—
    - (A) 2 years after the entry of the order for relief; or
    - (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. § 546(a)(1). The United States Court of Appeals for the Eighth Circuit recently examined the two-year look-back period of section 546(a) and held 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.” See *In re Raynor*, 617 F.3d 1065, 1071, 53 Bankr. Ct. Dec. (CRR) 144, 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).

<sup>21</sup>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.

11 U.S.C. § 544(b)(1). See generally *In re Adelpia Recovery Trust*, 634 F.3d 678, 692 n.6, 54 Bankr. Ct. Dec. (CRR) 89 (2d Cir. 2011); *In re Moore*, 608 F.3d 253, 259–61, 53 Bankr. Ct. Dec. (CRR) 68, Bankr. L. Rep. (CCH) P 81781 (5th Cir. 2010). 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).



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state fraudulent conveyance law, which in turn can offer a look-back period of four or more years.<sup>22</sup>

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.<sup>23</sup> With respect to the former, several cases discuss so-called “badges of fraud” in the context of circumstantial evidence of such intent.<sup>24</sup>

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<sup>22</sup>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 of the Bankruptcy Code 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). Alaska, Kentucky, Louisiana, Maryland, New York, South Carolina and Virginia have not adopted the UFTA. See Legislative Fact Sheet—Fraudulent Transfer Act of the National Conference of Commissioners on Uniform State Laws, available at [http://www.nccusl.org/LegislativeFactSheet.aspx?title=Fraudulent Transfer Act](http://www.nccusl.org/LegislativeFactSheet.aspx?title=Fraudulent%20Transfer%20Act) (last visited on May 7, 2012).

<sup>23</sup>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); *Friedrich v. Mottaz*, 294 F.3d 864, 869–70, 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 limitations on avoidance contained in §§ 546 and 548(c) of the Bankruptcy Code).

<sup>24</sup>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* was discussed at length in the 2011 edition of this article). See Maryann Gallagher, Section 548 and 550—Developments in the Law on Fraudulent Transfers and Recoveries, Norton Annual Survey of Bankruptcy Law 1119 (2011 ed.); see also *Adelphia Recovery Trust v. Bank of America, N.A.*, 624 F. Supp. 2d 292, 334–35 (S.D. N.Y. 2009) (margin lenders had reason to believe Adelphia was insolvent but

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.<sup>25</sup>

continued to accept loan payments in order to keep margin lending facilities open, thus prolonging fraud); *In re Frierdich*, 294 F.3d at 870, *supra*, note 23; *ASARCO LLC v. 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 the 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, 53 Bankr. Ct. Dec. (CRR) 268, 64 Collier Bankr. Cas. 2d (MB) 957 (Bankr. S.D. N.Y. 2010), leave to appeal denied, 2011 WL 3897970 (S.D. N.Y. 2011) (noting that many courts examine “badges of fraud” as a means of determining fraudulent intent based on circumstantial evidence) (*Merkin I* was discussed at length in the 2011 edition of this article, Gallagher, *supra* note 24, and a decision of the district court denying interlocutory review of the bankruptcy court decision is discussed in section III.B. of this article); *In re Phillips*, 379 B.R. 765, 778 (Bankr. N.D. Ill. 2007) (cumulative effect of the 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.’” (citations 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 circumstantial evidence to establish fraudulent intent, including “badges of fraud”).

<sup>25</sup>See, e.g., *In re TOUSA, Inc.*, 444 B.R. 613, 660 (S.D. Fla. 2011); see also *In re Southeast Waffles, LLC*, 460 B.R. 132, 139–40, 55 Bankr. Ct. Dec. (CRR) 233, Bankr. L. Rep. (CCH) P 82115, 2011-2 U.S. Tax Cas. (CCH) P 50740, 108 A.F.T.R.2d 2011-7337 (B.A.P. 6th Cir. 2011) (although reasonably equivalent value typically is a question of fact, payment prior to bankruptcy of tax penalty that reduced debtor’s tax liability on a dollar for dollar basis was made for rea-



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As noted above, however, BAPCPA has added 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.<sup>26</sup> This 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 inclu-

sonably equivalent value); *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 and finding that, with respect to indirect benefits, value is conferred “so long as there is some chance that a contemplated investment will generate a positive return at the time of the disputed transfer”); *In re TriGem America Corp.*, 431 B.R. 855, 867, 53 Bankr. Ct. Dec. (CRR) 110 (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); *Grochocinski 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 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 710 (the determination of “reasonably equivalent value” under § 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 Bankruptcy Code); *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 such value was not reasonably equivalent 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).

<sup>26</sup>The first change, discussed above, did little to broaden an already expansive definition of “transfer” in these provisions.

sion of a subtest specifically addressing transfers under employment contracts with respect to insiders<sup>27</sup> may actually act to bar recovery in such instances. By including such a provision in the constructive fraud section, 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.<sup>28</sup>

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-

(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;<sup>29</sup> or

(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.

<sup>27</sup>11 U.S.C. § 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”).

<sup>28</sup>Two recent decisions discussed at length in the 2011 edition of this article held that severance payments to former insiders were constructively fraudulent under section 548(a)(1)(B) because even though the executives were not insiders when the payments were made, they were insiders at the time the payments were arranged. See *In re TransTexas Gas Corp.*, 597 F.3d 298, 52 Bankr. Ct. Dec. (CRR) 199, Bankr. L. Rep. (CCH) P 81684 (5th Cir. 2010); *In re TSIC, Inc.*, 428 B.R. 103 (Bankr. D. Del. 2010). The defense asserting that executives were not insiders when the severance was paid failed because insider status is determined when the obligation to pay severance is incurred. The argument that prior services provided the reasonably equivalent value required to defeat an action seeking to avoid severance as a constructively fraudulent transfer under section 548(a)(1)(B)(ii)(IV) was not successful. *Id.*; see also Gallagher, *supra* note 24.

<sup>29</sup>One court determined that where a debtor’s business is a sole proprietorship, 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(b), preempting any attempt to use that section to avoid a charitable donation otherwise protected under section 548(a)(2).<sup>30</sup>

Bankruptcy courts have reviewed the plain meaning of the section, and concluded that the 15 percent limitation in section 548(a)(2)(A) is, in essence, a qualifying criterion for a transfer, not a measuring device for propriety.<sup>31</sup> Thus, if a transfer exceeds the 15 percent mark, even by a penny, the entire transfer will not be afforded the protections of section 548(a)(2)(A).<sup>32</sup> Another problem with section 548(a)(2) is that, as drafted, the provision applies to single transfers.<sup>33</sup> 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.<sup>34</sup> One should also note that in order

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<sup>30</sup>Section 544(b)(2) 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. § 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 § 548(a)(2) to provide guidance for a Chapter 13 plan).

<sup>31</sup>*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 § 548(a)(2) to be constitutional).

<sup>32</sup>It still may be afforded protection under § 548(a)(2)(B), if applicable. *See In re Zohdi*, 234 B.R. at 374–85.

<sup>33</sup>*Id.* at 380 n.20.

<sup>34</sup>*In re Jackson*, 249 B.R. 373, 377 (Bankr. D. N.J. 2000).

to invoke the protections of the Charitable Donation Act in this regard, the debtor must be a “natural person.”<sup>35</sup>

Section 548(b) sets out the avoidance powers by the trustee of a partnership debtor of transfers to general partners of the debtor,<sup>36</sup> and is rarely litigated.<sup>37</sup>

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.<sup>38</sup> Unless the transferee demonstrates<sup>39</sup> good faith and value,<sup>40</sup> the trustee

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<sup>35</sup> 11 U.S.C. § 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).

<sup>36</sup> 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. § 548(b).

<sup>37</sup> 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’s general partners who received payments otherwise in violation of § 548(b) may retain the payments if the criteria of § 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 § 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).

<sup>38</sup> 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. § 548(c).

<sup>39</sup> The defendant has the burden of showing good faith and value for purposes of section 548(c). See generally 5 Collier on Bankruptcy ¶¶ 548.09[2][c] and 548.11[1][b][iii] (Alan J. Resnick and Henry J. Sommer eds., 16th ed. 2012).

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will prevail.<sup>41</sup> Section 548(c) has been the topic of much litigation.<sup>42</sup>

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.<sup>43</sup> Except for the safe harbor provi-

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<sup>40</sup>Value for purposes of section 548 is defined as “property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor.” 11 U.S.C. § 548(d)(2)(A).

<sup>41</sup>See *In re Rosen Auto Leasing, Inc.*, 346 B.R. 798, 805–06, 46 Bankr. Ct. Dec. (CRR) 235 (B.A.P. 8th Cir. 2006).

<sup>42</sup>See *In re Dreier LLP*, 462 B.R. 474, 487 (Bankr. S.D. N.Y. 2011) (holding, among other things, that where complaint does not establish defendant’s affirmative good faith defense, defendant’s motion to dismiss on that basis would be denied); *In re Bernard L. Madoff Inv. Securities LLC*, 458 B.R. 87, 105, 55 Bankr. Ct. Dec. (CRR) 139 (Bankr. S.D. N.Y. 2011), leave to appeal denied, 464 B.R. 578 (S.D. N.Y. 2011); *In re Bayou Group, LLC*, 439 B.R. 284, 308 (S.D. N.Y. 2010) (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.’ ”); *In re Hill*, 342 B.R. 183, 203 (Bankr. D. 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 Merchandise, Inc.*, 371 F.3d 1056, 1060, 43 Bankr. Ct. Dec. (CRR) 49, Bankr. L. Rep. (CCH) P 80112 (9th Cir. 2004) (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).

<sup>43</sup>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.”

sion litigated on several occasions in 2001,<sup>44</sup> section 548(d) is rarely the subject of litigation.<sup>45</sup>

Section 548(e) addresses transfers to 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 was added by BAPCPA and is targeted at persons who seek to use self-settled trusts to avoid paying creditors. Commonly referred to as the "millionaire's loophole,"<sup>46</sup> the provision 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).<sup>47</sup> Under section 541(c)(2), restrictions on the transfer of beneficial interests in trusts that are "enforceable under applicable non-bankruptcy law" are made enforceable in a bankruptcy case (thereby causing such property to be excluded from

<sup>44</sup>*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); *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). 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. Compare *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).

<sup>45</sup>See *Friedrich 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) 1528 (N.D. Ill. 1999) (while collateralization of an antecedent debt may afford the debtor reasonably equivalent value under section 548(a)(1)(B)(i), reasonably equivalent value must be determined on a case-by-case basis).

<sup>46</sup>The language in section 548(e) was chosen over competing changes introduced in the House of Representatives under the title of the "Billionaire's Loophole Elimination Act." H.R. 1278, 109th Cong., 1st Sess. (March 14, 2005).

<sup>47</sup>11 U.S.C. § 541(c)(2).



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the debtor's bankruptcy estate).<sup>48</sup> Rather than revise section 541, however, Congress chose instead to alter the application of section 548 by implementing section 548(e).<sup>49</sup> 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.<sup>50</sup>

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<sup>48</sup>Gretchen Morgenson, Proposed Law on Bankruptcy Has Loophole, N.Y. Times, March 2, 2005. Five states (Alaska, Delaware, Nevada, Rhode Island and Utah) enacted such laws between 1997 and the implementation of BAPCPA. *Id.*

<sup>49</sup>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:

(A) such transfer was made to a self-settled trust or similar device;

(B) such transfer was by the debtor;

(C) the debtor is a beneficiary of such trust or similar device; and

(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).

11 U.S.C. § 548 (e).

<sup>50</sup>It should be noted that, unlike the changes with respect to insider transfers, this provision 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 BAPCPA's changes to section 548, section 548(e) was effective immediately upon enactment to cases commenced on or after that date. The impact of section 548(e) has been discussed in several cases. *See In re Mortensen*, 2011 WL 5025249, \*6–8 (Bankr. D. Alaska 2011) (transfers to a self-settled trust avoidable as fraudulent); *see also In re Porco, Inc.*, 447 B.R. 590, 594–97, 54 Bankr. Ct. Dec. (CRR) 153, Bankr. L. Rep. (CCH) P 81989 (Bankr. S.D. Ill. 2011) (constructive trust not a “similar device” to self-settled asset protection trust for avoidance under section 548(e)); *In re Mastro*, 465 B.R. 576 (Bankr. W.D. Wash. 2011) (transfers to self-settled trusts were avoidable as fraudulent); *In re Potter*, 2008 WL 5157877, \*8 (Bankr. D. N.M.

BAPCPA also made a number of changes to the treatment of financial contracts, as such are governed by section 548 and related sections of the Bankruptcy Code. 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,<sup>51</sup> or securities clearing agency,<sup>52</sup> or to a repurchase participant or financial participant in connection with a repurchase agreement<sup>53</sup> 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).<sup>54</sup> The same applies to transfers made by or to a swap participant or financial

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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); *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 section 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 (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”).

<sup>51</sup>11 U.S.C. § 101(22A) (defining “financial participant”).

<sup>52</sup>11 U.S.C. § 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 section 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 section 548(a)(1)(A) of this title.

<sup>53</sup>11 U.S.C. § 546(f) (BAPCPA added “financial participant” to this group).

<sup>54</sup>*See Picard v. Katz*, 462 B.R. 447, 451–52, 55 Bankr. Ct. Dec. (CRR) 133, Bankr. L. Rep. (CCH) P 82077 (S.D. N.Y. 2011), motion to certify appeal denied, 466 B.R. 208, 55 Bankr. Ct. Dec. (CRR) 266 (S.D. N.Y. 2012); *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329, 332, 55 Bankr. Ct. Dec. (CRR) 12, 65 Collier Bankr. Cas. 2d (MB) 1833 (2d Cir. 2011); *In re QSI Holdings, Inc.*, 571 F.3d 545, 548–49, 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).

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participant under or in connection with any swap agreements<sup>55</sup> 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. As those changes relate to section 548, they include the addition of “financial participants” to the various financial contract parties who may be deemed to take for value under section 548(d)(2)<sup>56</sup> and the inclusion of “master netting agreements” to the various types of financial contracts afforded the same protection.<sup>57</sup>

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. As noted by the FDIC, these changes “reduce systemic risk by providing greater clarity to the rights available to larger participants in markets.”<sup>58</sup> The latter change parallels the addition of section 561 of the Bankruptcy Code, clarifying the ability of counterparties to net payments across different categories of financial contracts<sup>59</sup> 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

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<sup>55</sup>See 11 U.S.C. § 546(g) (BAPCPA added “financial participant” to this group and changed the wording of this provision) and 11 U.S.C. § 546(j) (added by BAPCPA).

<sup>56</sup>See 11 U.S.C. § 548(d)(2)(B) to (D) (each adding “financial participants” to those who may take “for value” under certain financial contracts); *see also* 11 U.S.C. § 101(22A) (defining “financial participant”); *cf.* 11 U.S.C. § 546(e) to (g).

<sup>57</sup>11 U.S.C. § 548(d)(2)(E) (“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”).

<sup>58</sup>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).

<sup>59</sup>See 11 U.S.C. § 561; *see also* 11 U.S.C. §§ 101(38A) (defining “master netting agreement”) and 101(38B) (defining “master netting agreement participant”).

(the “Act of 2006”)<sup>60</sup> 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 Bankruptcy Code.<sup>61</sup> 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.<sup>62</sup>

<sup>60</sup>See Financial Netting Improvements Act of 2006, Pub. L. No. 109-390, § 5 (2006).

<sup>61</sup>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.

<sup>62</sup>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 *supra* note 52 for the language of section 546(e). Recent decisions addressing the safe harbor provided by section 546(e) include: *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329, 55 Bankr. Ct. Dec. (CRR) 12, 65 Collier Bankr. Cas. 2d (MB) 1833 (2d Cir. 2011) (safe harbor protected from avoidance early redemption payments of commercial paper as “settlement payments” within the meaning of section 741(8)); *Picard v. Katz*, 462 B.R. 447, 55 Bankr. Ct. Dec. (CRR) 133, Bankr. L. Rep. (CCH) P 82077 (S.D. N.Y. 2011), motion to certify appeal denied, 466 B.R. 208, 55 Bankr. Ct. Dec. (CRR) 266 (S.D. N.Y. 2012); *In re Magnesium Corp. of America*, 460 B.R. 360 (Bankr. S.D. N.Y. 2011); *In re Renew Energy LLC*, 463 B.R. 475, 55 Bankr. Ct. Dec. (CRR) 106, 66 Collier Bankr. Cas. 2d (MB) 636, Bankr. L. Rep. (CCH) P 82061 (Bankr. W.D. Wis. 2011); *In re Quebecor World (USA) Inc.*, 453 B.R. 201, 55 Bankr. Ct. Dec. (CRR) 60 (Bankr. S.D. N.Y. 2011); *In re MacMenamin’s Grill Ltd.*, 450 B.R. 414 (Bankr. S.D. N.Y. 2011); *In re D.E.I. Systems, Inc.*, 2011 WL 1261603 (Bankr. D. Utah 2011); *In re Mervyn’s Holdings, LLC*, 426 B.R. 488 (Bankr. D. Del. 2010). Several decisions, discussed in the 2010 edition 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). Sheikh, *supra* note 3, at III.C. 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.

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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 548 through the inclusion of sections 1521(a)(7) and 1523(a) of the Bankruptcy Code.<sup>63</sup> There is recent case law interpreting these sections.<sup>64</sup>

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).

<sup>63</sup>11 U.S.C. §§ 1521, 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 certain limited independent avoidance powers in the action pending under Chapter 15, while section 1523(a) appears to permit the foreign representative to exercise those broader avoidance powers should a case concerning the debtor exist under another Chapter of the Bankruptcy Code.

Section 1521 provides in relevant part:

- (a) Upon recognition of a foreign proceeding, whether main or non-main, 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—
  - (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. § 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. § 1523(a).

<sup>64</sup>See *In re Condor Ins. Ltd.*, 601 F.3d 319, 328–29, 52 Bankr. Ct. Dec. (CRR) 256, 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 Ins. Ltd.* was discussed in detail in section III.D. of the 2011 edition of this article. Gallagher, *supra* note 24. A recent bankruptcy court decision favorably cited the Fifth Circuit's holding in *In re Condor Ins. Ltd.* 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 International Banking Corp. B.S.C.*, 439 B.R. 614, 629, 53 Bankr. Ct. Dec. (CRR) 279 (Bankr. S.D. N.Y. 2010); see also *In re Fairfield Sentry Ltd. Litigation*, 458 B.R. 665 (S.D. N.Y. 2011) (reversing bankruptcy court and holding that bankruptcy court lacked jurisdiction over claims of Foreign Representatives of offshore funds because the assets sought were located outside of the United States); *In re Awal Bank, BSC*, 455 B.R. 73, 55 Bankr. Ct. Dec. (CRR) 97, 75 U.C.C. Rep. Serv. 2d 245 (Bankr. S.D. N.Y. 2011) (External Administrator's action to recover a set-off pursuant to § 553(b) not precluded by § 1521(a)(7) of the Bankruptcy Code); *In re Atlas Shipping A/S*, 404 B.R. 726, 744, 51 Bankr. Ct. Dec. (CRR) 145, 61 Collier Bankr. Cas. 2d



## 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.”<sup>65</sup>

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 1898.”<sup>66</sup> As noted below with respect to *Deprizio*,<sup>67</sup> 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 extra-territoriality”<sup>68</sup> and also has survived at least one sovereign immunity challenge in which the Supreme Court held that Congress

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(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”).

<sup>65</sup>*In re Coleman*, 299 B.R. 780, 788–89, 92 A.F.T.R.2d 2003-7145 (W.D. Va. 2003) (citing H.R. Rep. No. 595, 95th Cong., 1st Sess. 375 (1977), reprinted in 1978 U.S.C.C.A.N. pp. 5787, 5963, 6331); *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).

<sup>66</sup>*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] (James W. Moore ed., 14th ed. 1982)) (addressing problems regarding transfers among family-owned operations or corporations with single shareholders).

<sup>67</sup>*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).

<sup>68</sup>*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 do-



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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.”<sup>69</sup>

mestic 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 Env’t. 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*).

<sup>69</sup>*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 States’ interests are affected”). Although the Supreme Court in *Katz* declined to decide “whether actions to recover preferential transfers pursuant to [§ 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 to avoid preferential transfers and to recover the transferred property” from states. *Id.* 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, 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. *Id.* at 363. *But see 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). In *360networks*, the United States 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, 453, 124 S. Ct. 1905, 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 agree-

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:<sup>70</sup>

(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:

- (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
- (2) any immediate or mediate transferee of such initial transferee.<sup>71</sup>

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ment between the parties. The parties specifically cited the then-upcoming Supreme Court decision in *Katz* as a reason to grant vacature.

<sup>70</sup>Due to 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.

<sup>71</sup>The Court of Appeals for the Eleventh Circuit as well as other lower courts have 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); *Picard v. Katz*, 466 B.R. 208, 214, 55 Bankr. Ct. Dec. (CRR) 266 (S.D. N.Y. 2012) (stating that section 550(a) permits avoidance of a subsequent transfer where the initial transfer could have been avoided); *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 for whose benefit the transfer is made."); *see also In re Taylor*, 390 B.R. 654, 666 (B.A.P. 9th Cir. 2008); *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 *Int'l Admin. Svcs., 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 (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 avoid-

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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.<sup>72</sup>

Initially, section 550(a)(1) did not grant the ability to recover from the “entity for whose benefit such transfer was made.”<sup>73</sup> This language was added as a part of the 1984 Amendments. In adding this provision, Congress specifically noted two limitations: (i) that no duplicate recoveries should be permitted,<sup>74</sup> and (ii) that the recovery is only permissible to the extent of actual avoidance.<sup>75</sup>

The Bankruptcy Code does not define initial, immediate or me-

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ance 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). See generally *In re M. Fabrikant & Sons, Inc.*, 394 B.R. 721, 742–46, 50 Bankr. Ct. Dec. (CRR) 192 (Bankr. S.D. N.Y. 2008) (discussing the conflict among the courts and holding that a trustee must always avoid a transfer against a subsequent transferee unless collateral estoppel or res judicata applies, thus allowing a trustee to settle with the initial transferee and pursue subsequent transferee, or pursue a subsequent transferee when unable to sue the initial transferees).

<sup>72</sup>*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 non-debtor. The value recovered would be that which the debtor would obtain should it sell the property. *Id.* at 674.

<sup>73</sup>See *In re LGI Energy Solutions, Inc.*, 460 B.R. 720, 725, 55 Bankr. Ct. Dec. (CRR) 235, 66 Collier Bankr. Cas. 2d (MB) 1329 (B.A.P. 8th Cir. 2011) (relying solely on language of section 550(a)(1) of the Bankruptcy Code which stated trustee could recover from either defendant utility providers who received payments from debtor utility management and billing service provider, or from customers whose accounts were credited as a result of payments to utilities by debtor). See section III.A. of this article for a detailed discussion of *TOUSA II*'s analysis of section 550(b)(1).

<sup>74</sup>See 11 U.S.C. § 550(d).

<sup>75</sup>11 U.S.C. § 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 repay-

diate 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,<sup>76</sup> whether the recipient was a "mere conduit,"<sup>77</sup> or whether a transferee received a benefit from the transfer,<sup>78</sup> but no clear-cut test exists and courts continue to struggle with this requirement.<sup>79</sup>

ments made to reduce liability following an avoidable fraudulent transfer under § 548).

<sup>76</sup>For a case discussion of recovery from such entities, see *In re Harwell*, 628 F.3d 1312, 1322–23, 54 Bankr. Ct. Dec. (CRR) 12, 64 Collier Bankr. Cas. 2d (MB) 1820, Bankr. L. Rep. (CCH) P 81909 (11th Cir. 2010); *Paloian v. LaSalle Bank, N.A.*, 619 F.3d 688, 691–92, 53 Bankr. Ct. Dec. (CRR) 155, 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) (*In re Harwell* and *Paloian* are discussed in greater detail in section III.C. of this article); see also *Rupp v. Markgraf*, 95 F.3d 936, 29 Bankr. Ct. Dec. (CRR) 834, 36 Collier Bankr. Cas. 2d (MB) 1312 (10th Cir. 1996) (bank acting as conduit without dominion and control over funds transferred by debtor to a third party which is not an initial transferee); *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 with dominion over the money or other asset, the right to put the money to one's own purposes") (citations omitted); *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") (citations omitted); *In re Sunglasses and Then Some, Inc.*, 51 Bankr. Ct. Dec. (CRR) 257, 2009 WL 2058564, \*4 (Bankr. D. Mass. 2009) (in interpreting the definition of "transferee," the court determined that defendant principals or the 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, 216, 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") (citations omitted).

<sup>77</sup>See *In re Harwell*, 628 F.3d 1312, 54 Bankr. Ct. Dec. (CRR) 12, 64 Collier Bankr. Cas. 2d (MB) 1820, Bankr. L. Rep. (CCH) P 81909 (11th Cir. 2010); *Paloian*, 619 F.3d at 691–692; *In re Pony Exp. Delivery Services, Inc.*, 440 F.3d 1296, 46 Bankr. Ct. Dec. (CRR) 24, Bankr. L. Rep. (CCH) P 80465 (11th Cir. 2006); *In re International Administrative Services, Inc.*, 408 F.3d 689, 44 Bankr. Ct. Dec. (CRR) 178, Bankr. L. Rep. (CCH) P 80279 (11th Cir. 2005); *In re Chase & Sanborn Corp.*, 813 F.2d 1177, Bankr. L. Rep. (CCH) P 71753 (11th Cir. 1987); *In re Chase & Sanborn Corp.*, 848 F.2d 1196, Bankr. L. Rep. (CCH) P 72363 (11th Cir. 1988); *In re Warnaco Group, Inc.*, 97 A.F.T.R.2d 2006-958, 2006 WL 278152 (S.D. N.Y. 2006); *In re Elrod Holdings Corp.*, 394 B.R. 751, 60 Collier Bankr. Cas. 2d (MB) 1020 (Bankr. D. Del. 2008).

<sup>78</sup>See *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

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Section 550(b) provides for separate treatment of 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 without knowledge of the voidability of the transfer 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 she may assert a good faith and for value defense pursuant to section 550(b).<sup>80</sup> Nonetheless, the legislative history to section 550 makes it clear that the recovery provisions only apply to the

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(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”) (citations omitted); *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).

<sup>79</sup>See, e.g., *Paloian*, 619 F.3d at 691–92 (see discussion at section III.C. of this article); *In re Meredith*, 527 F.3d at 376–77, *supra* note 78; *In re Antex, Inc.*, 397 B.R. at 173 (controlling a corporation and causing checks to be issued does not make a principal of a corporation an initial transferee, since after the 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, even 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 (*supra* note 76); *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).

<sup>80</sup>See, e.g., *In re Nieves*, 648 F.3d 232, 242, 65 Collier Bankr. Cas. 2d (MB) 1442, Bankr. L. Rep. (CCH) P 82024 (4th Cir. 2011) (subsequent transferee may assert good faith defense, but good faith must be determined under an objective standard and as such courts should analyze what the transferee knew or should have known); *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. See 11 U.S.C. § 550(a). If the recipient was not the initial transferee, however, he or she may



extent a transaction is avoidable.<sup>81</sup> Thus, if the underlying avoidance statute contains defenses,<sup>82</sup> those defenses will be effective regardless of the strict liability of initial transferees<sup>83</sup> provided in section 550(a).<sup>84</sup>

Section 550(c)<sup>85</sup> was added by the 1994 Reform Act in response to the *Deprizio* case regarding preferential transfers involving

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assert a good faith defense.”); *In re Bower*, 462 B.R. 347, Bankr. L. Rep. (CCH) P 82143 (Bankr. D. Mass. 2012) (mortgage assignee who took for value not protected by § 550(b) because a defect on the face of mortgage made assignee aware of facts that would have alerted a reasonable person to avoidability of mortgage under Massachusetts law); *In re Resource, Recycling & Remediation, Inc.*, 314 B.R. 62, 70–71, 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 it to the employee in return for disposing of barrels of ink, took “for value” under section 550(b)). Courts are split on the placement of the burden of proof under section 550(b), but it appears that the better reasoned position is that the transferee has the burden of showing good faith, value and lack of knowledge. *See* 5 Collier on Bankruptcy ¶ 550.03[5] (Alan J. Resnick and Henry J. Sommer eds., 16th ed. 2012).

<sup>81</sup>*See* H. R. Rep. No. 95-595 (1977); S. Rep. No. 95-989 (1978).

<sup>82</sup>*See, e.g.*, 11 U.S.C. §§ 548(c) & 546(e).

<sup>83</sup>For cases recognizing that initial transferees of avoided transfers are strictly liable under § 550(a), *see, e.g.*, *In re Red Dot Scenic, Inc.*, 351 F.3d 57, 58 (2d Cir. 2003); *In re Hurtado*, 342 F.3d at 532–33; *In re Ogden*, 314 F.3d 1190, 1196, 40 Bankr. Ct. Dec. (CRR) 208, Bankr. L. Rep. (CCH) P 78794 (10th Cir. 2002); *In re Cohen*, 300 F.3d 1097, 1102, 40 Bankr. Ct. Dec. (CRR) 9, 48 Collier Bankr. Cas. 2d (MB) 1397, Bankr. L. Rep. (CCH) P 78706, 48 U.C.C. Rep. Serv. 2d 469 (9th Cir. 2002).

<sup>84</sup>*See In re Teleservices Group, Inc.*, 444 B.R. 767, 790–95 (Bankr. W.D. Mich. 2011) (section 548(c), not section 550(b), is the sole good faith defense for initial transferees of allegedly fraudulent transfers); *In re General Search.com*, 322 B.R. 836, 842, 54 Collier Bankr. Cas. 2d (MB) 46 (Bankr. N.D. Ill. 2005) (same); *In re H. King & Assocs.*, 295 B.R. at 285–86 (same); *In re Food & Fibre Protection, Ltd.*, 168 B.R. 408, 419–20, 25 Bankr. Ct. Dec. (CRR) 1019 (Bankr. D. Ariz. 1994) (same); *see also Nelmark v. Helms*, 2003 WL 1089363, \*3–5 (N.D. Ill. 2003) (upholding bankruptcy court determination that defendants were initial transferees who were not entitled to defense of section 550(b) and who did not prove they had acted in good faith for purposes of section 548(c)).

<sup>85</sup>Section 550(c) of the Bankruptcy Code provides:

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.

11 U.S.C. § 550(c).



insiders.<sup>86</sup> 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 guaranteed by insiders of the debtor or which were secured by collateral in which the insiders had an interest.<sup>87</sup> The lender was not considered an insider.<sup>88</sup> The Court held that the trustee could recover the payment from the lender, even though the lender was not an insider, because the transfer benefited the insider.<sup>89</sup> 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.<sup>90</sup>

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<sup>91</sup> 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) clarifies that recovery for preferential transfers cannot be sought from the non-insider initial transferee under such facts.<sup>92</sup> However, this clarification is

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<sup>86</sup>*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).

<sup>87</sup>*Id.* at 1187–88.

<sup>88</sup>*Id.* at 1198.

<sup>89</sup>*Id.* at 1200–01.

<sup>90</sup>*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 non-insider 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).

<sup>91</sup>*See* H. R. Rep. No. 103-835; 1994 U.S.C.C.A.N. 3340.

<sup>92</sup>*See In re Exide Techs., Inc.*, 299 B.R. at 746; *In re Mid-South Auto Brokers, Inc.*, 290 B.R. at 662.

still subject to debate, largely because Congress continued to mistake the distinction between avoidance and recovery.<sup>93</sup>

<sup>93</sup>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) (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 non-possessory 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, 805–06, 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 non-insider lender); *In re Williams*, 234 B.R. 801, 803–05, 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 with respect to preferential transfers, 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. § 547(i). Two possible problems with this 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. § 101(10) (defining "creditor") *with* 11 U.S.C. § 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." In one of few decisions discussing section 547(i), a bankruptcy court in Wisconsin considered whether a debtor's son who guaranteed the debtor's loan was a creditor for purposes section 547(i) and found that absent a waiver of contribution or indemnification rights in the

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

Section 550(d) states that “[t]he trustee is entitled to only a single satisfaction under subsection (a) of this section” and has generated little but confirming case law.<sup>94</sup>

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 postpetition.<sup>95</sup> The district court found that while the strict requirements for recovery under section 550 had been met, the postpetition 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).<sup>96</sup>

Section 550(e) provides limited 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.<sup>97</sup> The statute clearly intends that this section only

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guarantee, the son was considered a creditor. *In re Halling*, 449 B.R. 911, 915–16 (Bankr. W.D. Wis. 2011).

<sup>94</sup>See *In re Sherman*, 67 F.3d 1348, 1358, 27 Bankr. Ct. Dec. (CRR) 1237, 34 Collier Bankr. Cas. 2d (MB) 655, Bankr. L. Rep. (CCH) P 76671 (8th Cir. 1995) (double recovery prohibited); *In re Skywalker, 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, 628–29 (S.D. Ga. 2008) (same); *In re G-I Holdings, Inc.*, 2006 WL 1751793, \*15 (D.N.J. 2006) (same); *In re Cybridge Corp.*, 312 B.R. 262, 268–69, 43 Bankr. Ct. Dec. (CRR) 81, 52 Collier Bankr. Cas. 2d (MB) 615 (D.N.J. 2004) (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); 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 transfer under federal law. See *In re IVDS Interactive Acquisition Partners*, 302 Fed. Appx. 574, 576–77 (9th Cir. 2008) (partnership’s founders were jointly and severally liable on a recovery action for funds fraudulently transferred from the partnership).

<sup>95</sup>*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).

<sup>96</sup>*Id.*

<sup>97</sup>Section 550(e) provides:

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, 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.<sup>98</sup>

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.”<sup>99</sup> Section 550(f) is jurisdictional in nature,

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(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.

11 U.S.C. § 550(e).

<sup>98</sup>*In re Burns*, 322 F.3d at 427, *supra* note 93 (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).

<sup>99</sup>*See 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) (“The transaction must first be avoided before a plaintiff can recover under 11 U.S.C. § 550. . . . This demarcation between avoidance and recovery is underscored by § 550(f), which places a separate statute of limitations on recovery actions; it provides that a suit for recovery must be commenced within one year of the time that the transaction is avoided or by the time the case is closed or dismissed, whichever occurs first”); *see also 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 on other grounds and remanded*, 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).

and is not waived by the defendant's failure to timely plead.<sup>100</sup> Note that the time frame runs from the date the transfer was avoided, not the date of the transfer.<sup>101</sup>

### III. CASE LAW DEVELOPMENTS IN 2011

This section summarizes and analyzes certain decisions issued in 2011 addressing portions of sections 548 and/or 550 of the Bankruptcy Code that the author believes to be of import and general interest to bankruptcy practitioners. This section 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 which courts have considered during the past year.

#### A. *TOUSA*—Heightened Standards for Lenders Accepting Repayment

In February 2011, the United States District Court for the Southern District of Florida in an appeal from an avoidance action in the case of *In re TOUSA, Inc.*<sup>102</sup> reversed and quashed the portions of a controversial 2009 bankruptcy court decision (a) finding that liens granted in connection with loans whose proceeds were used to pay former lenders were constructively fraudulent and (b) ordering disgorgement of those proceeds.<sup>103</sup>

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<sup>100</sup>*In re Sandoval*, 470 B.R. 195, 200 (Bankr. D. N.M. 2012); *In re Phimmassone*, 249 B.R. 681, 683, 44 Collier Bankr. Cas. 2d (MB) 890 (Bankr. W.D. Va. 2000).

<sup>101</sup>*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).

<sup>102</sup>*TOUSA II*, 444 B.R. at 613.

<sup>103</sup>*Id.* at 680. On March 22, 2012, the United States Bankruptcy Court for the Southern District of Florida approved a partial settlement among the Conveying Subsidiaries (defined herein), the Committee (defined herein) and certain of the Transeastern Lenders (defined herein) that provides a floor and ceiling for recovery from the settling Transeastern Lenders and relieves those lenders of certain bonding requirements. However, this partial settlement contemplated that the appeal to the Eleventh Circuit would continue and thus did not resolve the merits of the Committee's appeal of the district court decision, discussed herein, and the Committee's pursuit of recovery from the non-settling Transeastern Lenders. See Order Approving Settlement Agreement Among the Committee, the Conveying Subsidiaries, Monarch Alternative Capital LP, as Investment Advisor to Monarch Master Funding Ltd, JPMorgan Chase Bank, N.A., and Bear Stearns Investment Products Inc., *In re TOUSA, Inc.*, No. 08-10928 (March 22, 2012).

The bankruptcy court<sup>104</sup> had held that liens granted and obligations incurred by the parent's subsidiaries in exchange for a new loan used to make payments to settle litigation involving only the parent and other subsidiaries were not in exchange for reasonably equivalent value and ordered, inter alia, disgorgement by the lenders who received the proceeds. As a result, even though the district court addressed only the appeals of the recipients of the loan proceeds, the opinion was highly anticipated and ranked as one of the most discussed bankruptcy decisions of 2011.<sup>105</sup> On May 15, 2012, in a subsequent appeal, the United States Court of Appeals for the Eleventh Circuit reversed the district court's decision, affirmed the decision of the bankruptcy court and remanded to the district court for consideration the issues of judicial assignment, consolidation and remedies.<sup>106</sup>

### 1. *Factual Background*

TOUSA, Inc. ("TOUSA") and its subsidiaries designed, built and marketed residential real estate developments in the Florida region.<sup>107</sup> Prior to the transactions at issue, TOUSA's business was financed through over \$1 billion of unsecured bond debt (the "Bonds"), with TOUSA as the primary obligor on the Bonds, and its subsidiaries jointly and severally liable as guarantors.<sup>108</sup> TOUSA was also the borrower under a secured revolving loan facility (the "Revolver"), and several of its subsidiaries acted as guarantors of TOUSA's obligations under the Revolver.<sup>109</sup> As would become crucial at trial, both the indentures governing the Bonds and the agreements governing the Revolver contained provisions (the "Trigger Clauses") specifying that any judgment over

<sup>104</sup>*TOUSA I*, 422 B.R. at 783. The *TOUSA I* decision was discussed in the 2010 edition of this article. See Sheikh, *supra* note 3. The district court in *TOUSA II* cited to the 2010 edition of this article. *TOUSA II*, 444 B.R. at 676.

<sup>105</sup>The appeals of *TOUSA I* were not consolidated. *TOUSA II* addressed only the appeals of one group of lenders to a failed joint venture to which TOUSA was a partner, in which lenders received the proceeds of the new loan made pursuant to a settlement resolving litigation that did not involve the subsidiaries of TOUSA. The remaining appeals of *TOUSA I* were stayed pending the Committee's (herein defined) appeal of *TOUSA II* to the Eleventh Circuit Court of Appeals. See Order Staying and Administratively Closing Case, Wells Fargo Bank, NA v. Official Comm. of Unsecured Creditors, No. 10-cv-60018 (S.D. Fla. March 28, 2011).

<sup>106</sup>*In re TOUSA, Inc.*, 680 F.3d 1298, 1316, 56 Bankr. Ct. Dec. (CRR) 135 (11th Cir. 2012).

<sup>107</sup>*TOUSA II*, 444 B.R. at 620.

<sup>108</sup>*Id.* at 622–23.

<sup>109</sup>*Id.* at 625–26, 638.



\$10 million involving TOUSA or any of its subsidiaries would constitute an event of default, making all outstanding amounts of principal and interest on the Bonds and Revolver immediately due and payable.<sup>110</sup> Such a default would likely have led to bankruptcy filings by TOUSA and its subsidiaries.<sup>111</sup>

a. The Joint Venture Litigation and Settlement

In 2007, due to the failure of a joint venture involving TOUSA, certain of TOUSA's subsidiaries, and a third party, TOUSA became enmeshed in litigation with the lenders to the joint venture (the "Transeastern Lenders").<sup>112</sup> In light of the Trigger Clauses, and because TOUSA's principals predicted that an adverse judgment over \$10 million was extremely likely,<sup>113</sup> TOUSA entered into a settlement agreement with the Transeastern Lenders (the "Settlement") whereby TOUSA agreed to pay the Transeastern Lenders approximately \$421 million.<sup>114</sup> To finance the Settlement, TOUSA and its subsidiaries borrowed approximately \$500 million in new secured debt (the "New Loan"), even though the subsidiaries were not liable for the joint venture indebtedness, were not party to the ensuing litigation and received none of the proceeds of the New Loan, as the proceeds were earmarked specifically to fund the Settlement.<sup>115</sup> TOUSA and its subsidiaries (the "Conveying Subsidiaries") were required to pledge their assets to the New Loan lenders (the "New Lenders") as security for the New Loan.<sup>116</sup> In order to ensure that the New Lenders' liens ranked equal in priority to the pre-existing liens of the Revolver lenders, the Conveying Subsidiaries secured the Revolver lenders' consent.<sup>117</sup>

As part of the Settlement, TOUSA received assets and several

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<sup>110</sup>*Id.* at 622–23, 625–26.

<sup>111</sup>*Id.* at 632.

<sup>112</sup>*Id.* at 630. TOUSA was a co-borrower with the other joint venture party on the loans provided by the Transeastern Lenders to the joint venture.

<sup>113</sup>In *TOUSA II*, the district court quoted from testimony, noting that "TOUSA management believed that 'the senior lenders [to the Senior Credit Agreement] were entitled to get 100 percent cash. Everyone took the position if we didn't pay them 100 percent, we had no deal . . . Certainly, we had a series of advisors, and the decision was that there was no sense spending time trying to negotiate with them.'" *Id.* at 632 (citations omitted).

<sup>114</sup>*Id.* at 633.

<sup>115</sup>*Id.* at 634.

<sup>116</sup>The Conveying Subsidiaries also provided guaranties for the obligations under the New Loan. *Id.* at 634–35.

<sup>117</sup>*Id.*

properties owned by the joint venture, the deposits previously held by the joint venture, and the proceeds of sold assets which were available to all TOUSA entities, including the Conveying Subsidiaries.<sup>118</sup> The acquisition of these assets increased the borrowing base on the Revolver by approximately \$150 million, again to the benefit of all TOUSA entities, including the Conveying Subsidiaries.<sup>119</sup> The officers and directors of TOUSA and the Conveying Subsidiaries executed formal resolutions or consents approving the companies' obligations under the New Loan, all containing language recognizing that the acquisition of the new debt was in the "best interest" and for the "benefit" of TOUSA and the Conveying Subsidiaries.<sup>120</sup> Further, the Settlement created approximately \$74.8 million in future tax benefits for TOUSA and the Conveying Subsidiaries.<sup>121</sup> Although TOUSA's management intended for the Settlement to prevent the enterprise's bankruptcy, the sharp decline of the real estate market and other factors led TOUSA and most of its subsidiaries to file for bankruptcy protection on January 29, 2008, less than six months after the Settlement.<sup>122</sup>

b. The Avoidance Actions Attacking the Settlement

In July 2008, the official committee of unsecured creditors appointed in the bankruptcy cases (the "Committee") commenced adversary proceedings seeking to avoid as constructively fraudulent transfers the liens and guaranties conveyed to the New Lenders by the Conveying Subsidiaries and to recover the proceeds of the New Loan paid to the Transeastern Lenders.<sup>123</sup> Among other things, the Committee argued that the Conveying Subsidiaries were either insolvent at the time of the transfers related to the New Loan and the Settlement or were made insolvent by those transfers and did not receive reasonably equivalent value when they pledged their assets to the New Lenders in return for the New Loan, the proceeds of which were used to satisfy TOUSA's obligations to the Transeastern Lenders in a litigation to which the Conveying Subsidiaries were not parties.<sup>124</sup>

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<sup>118</sup>*Id.* at 633.

<sup>119</sup>*Id.*

<sup>120</sup>*Id.* at 635.

<sup>121</sup>*Id.* at 636.

<sup>122</sup>*Id.* at 637.

<sup>123</sup>*Id.*

<sup>124</sup>*TOUSA I*, 422 B.R. at 786.

2. *TOUSA I—Transfers Related to New Loan Found Constructively Fraudulent*

After a lengthy trial, the bankruptcy court ruled in favor of the Committee, ordering the avoidance of the liens and obligations granted to the New Lenders as constructively fraudulent transfers pursuant to section 548(a)(1)(B) of the Bankruptcy Code and the disgorgement from the Transeastern Lenders of the proceeds of the New Loan they received in the Settlement.<sup>125</sup> The bankruptcy court found that the obligations incurred and the liens granted by the Conveying Subsidiaries, as well as the payments made to the Transeastern Lenders, were avoidable because the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for their transfers.<sup>126</sup> The bankruptcy court held that the Conveying Subsidiaries received “no direct value” and, if they received “any value at all, it was minimal and did not come anywhere near the millions of dollars of obligations they incurred.”<sup>127</sup> In so holding, the bankruptcy court explicitly rejected the Transeastern Lenders’ argument that the value they provided included that the New Loan prevented the immediate bankruptcies of TOUSA and its subsidiaries, stating that the Conveying Subsidiaries received “minimal indirect benefits” because the “[t]ransaction did not in fact prevent the bankruptcy of the parent company” and because “the Conveying Subsidiaries would not have been seriously harmed by such an earlier bankruptcy.”<sup>128</sup>

In addressing the Transeastern Lenders’ argument that a judgment against TOUSA in the joint venture litigation would have caused a default under the Revolver that would have certainly led to the Conveying Subsidiaries’ bankruptcies, the bankruptcy court held that there was “no reason to believe that the Conveying Subsidiaries could not have dealt with a possible Revolver

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<sup>125</sup>*Id.* at 843–44, 883–86. The bankruptcy court, in so finding, concluded that the Conveying Subsidiaries received less than reasonably equivalent value for the obligations they incurred, and: (i) were insolvent both before and after the transaction; (ii) were left with unreasonably small capital with which to continue operations after the transaction; and (iii) incurred debts that went beyond their ability to pay as such debts matured as a result of the transaction. *Id.* at 858–69. See section II.A. of this article for the language of section 548(a) of the Bankruptcy Code.

<sup>126</sup>*TOUSA I*, 422 B.R. at 858–69, 872–75.

<sup>127</sup>*Id.* at 844.

<sup>128</sup>*Id.* at 846. Although not an issue in *TOUSA II*, the bankruptcy court found that certain “savings clauses” in the loan documents, which were intended to protect the lenders from fraudulent transfer claims, were invalid. *Id.* at 863–64.

default by transitioning to an alternative source of financing.”<sup>129</sup> The bankruptcy court made this finding despite undisputed testimony from TOUSA’s management that no alternative financing was available to the Conveying Subsidiaries.<sup>130</sup>

The bankruptcy court also held that the New Lenders and the Transeastern Lenders did not act in “good faith” for purposes of shielding avoidance and/or liability under the affirmative defenses of sections 548(c) and 550(b) of the Bankruptcy Code.<sup>131</sup> The bankruptcy court found that the New Lenders and Transeastern Lenders were, respectively, grossly negligent when they funded the New Loan and accepted the proceeds of the New Loan, because at the time of the transfers there existed “overwhelming evidence that TOUSA was financially distressed.”<sup>132</sup> The bankruptcy court determined that the New Lenders and the Transeastern Lenders had a duty to investigate the financial condition of TOUSA and the Conveying Subsidiaries, and that, based upon available information, they knew or should have known that TOUSA and the Conveying Subsidiaries either were or were close to becoming insolvent at the time of the Settlement.<sup>133</sup>

### 3. *TOUSA II—Reversal of All Rulings Related to Transeastern Lenders*

Both the Transeastern Lenders and the New Lenders appealed<sup>134</sup> the bankruptcy court’s factual findings and legal conclusions<sup>135</sup> and, in *TOUSA II*, the district court reversed the bankruptcy court’s decision on every major issue with respect to the

<sup>129</sup>*TOUSA II*, 444 B.R. at 641 (citing *TOUSA I*, 422 B.R. at 847).

<sup>130</sup>*Id.* at 633.

<sup>131</sup>*TOUSA I*, 422 B.R. at 869 (finding New Lenders did not act in good faith for purposes of section 548(c)); *id.* at 877 (finding Transeastern Lenders did not act in good faith for purposes of section 548(c)); *id.* at 875–76 (Transeastern Lenders not entitled to rely on the section 550(b) good faith defense because they had not acted in good faith).

<sup>132</sup>*Id.* at 850–55.

<sup>133</sup>*Id.*

<sup>134</sup>The appeals were split between two judges, with Judge Alan Gold handling the appeals of the Transeastern Lenders and Judge Adalberto Jordan handling the appeals of the New Lenders. Following the *TOUSA II* decision, the New Lenders’ appeals were stayed pending a determination by the Eleventh Circuit Court of Appeals. See Order Staying and Administratively Closing Case, Wells Fargo Bank, NA v. Official Committee of Unsecured Creditors, No. 10-cv-60018 (S.D. Fla. March 28, 2011).

<sup>135</sup>The district court conducted a de novo review of the bankruptcy court’s legal determinations and applies a “clearly erroneous” standard of review to the bankruptcy court’s findings of fact. *TOUSA II*, 444 B.R. at 643 (citing *In re*

Transeastern Lenders.<sup>136</sup> In a lengthy and scathing opinion, the district court took a highly unusual step when, rather than remanding the case to the bankruptcy court, it simply quashed<sup>137</sup> the bankruptcy court's substantive rulings.

a. Reasonably Equivalent Value

A central issue in the Transeastern Lenders' appeal to the district court was the question of whether, for purposes of section 548(a)(1)(B) of the Bankruptcy Code, the Conveying Subsidiaries received "reasonably equivalent value"<sup>138</sup> in exchange for their liens and obligations to the New Lenders as well as for the transfers of proceeds to the Transeastern Lenders.<sup>139</sup> The district court ruled that the bankruptcy court's holdings in this regard were clearly erroneous.<sup>140</sup> While the bankruptcy court rejected

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*Trusted Net Media Holdings, LLC*, 550 F.3d 1035, 1038 n.2, 50 Bankr. Ct. Dec. (CRR) 254, 61 Collier Bankr. Cas. 2d (MB) 292, Bankr. L. Rep. (CCH) P 81366 (11th Cir. 2008)). The court in *TOUSA II* noted that the "clearly erroneous" standard would be relaxed because the bankruptcy court's order was "practically a verbatim adoption of the Committee's Proposed Findings of Fact and Conclusions of Law submitted after the trial . . . Of the Committee's 448 proposed findings and conclusions, the bankruptcy court adopted 446 in whole or in part, while adopting *none* of the defendants' over 1,600 proposed findings." *Id.* at 643–44 (emphasis supplied).

<sup>136</sup>*Id.* at 643. The following two questions were presented by the Transeastern Lenders: (i) "Whether the Transeastern Lenders can be compelled to disgorge to the Conveying Subsidiaries funds paid by TOUSA to satisfy a legitimate uncontested debt, where the Conveying Subsidiaries did not control the transferred funds"; and (ii) "Whether the Transeastern Lenders are liable for disgorgement as the entities 'for whose benefit' the Conveying Subsidiaries transferred the Liens to the New Lenders, where the Transeastern Lenders received no direct and immediate benefit from the Lien Transfer." *Id.* at 642.

<sup>137</sup>The *TOUSA II* court noted that where "the factual record allows but one 'resolution of the factual issue,' remand is unnecessary." *Id.* at 645 (quoting *Pullman-Standard v. Swint*, 456 U.S. 273, 292, 102 S. Ct. 1781, 72 L. Ed. 2d 66, 28 Fair Empl. Prac. Cas. (BNA) 1073, 28 Empl. Prac. Dec. (CCH) P 32619, 33 Fed. R. Serv. 2d 1501 (1982)); *see also* Jessica D. Gabel, *The Terrible Tousas: Opinions Test the Patience of Corporate Lending Practices*, 27 Emory Bankr. Dev. J. 415, 427 (2011) ("A review of bankruptcy appeals reveals fewer than five reported decisions where an order was quashed. The more common and perhaps more defensible on appeal approach is to remand the case to the bankruptcy court.").

<sup>138</sup>"[T]he burden of proving lack of reasonably equivalent value . . . rests on the trustee challenging the transfer," even in the context of an indirect value analysis. *TOUSA II*, 444 B.R. at 649–650 (citations omitted).

<sup>139</sup>There was no dispute that the Transeastern Lenders were owed the amounts paid pursuant to the Settlement. *Id.* at 645.

<sup>140</sup>*Id.* at 667.



the Transeastern Lenders' argument that the Conveying Subsidiaries' potential opportunity to avoid bankruptcy as a result of the Settlement constituted value, the district court found it to be meritorious, holding that "indirect, intangible, economic benefits, including the opportunity to avoid default, to facilitate the enterprise's rehabilitation, and to avoid bankruptcy, even if it provided to be short lived, may be considered in determining reasonably equivalent value. An expectation, such as in this case, that a settlement which would avoid default and produce a strong synergy for the enterprise, would suffice to confer 'value' so long as that expectation was legitimate and reasonable."<sup>141</sup> The district court opined that the bankruptcy court's ruling was "contrary to well-established law which holds that indirect benefits may take many forms, both tangible and intangible"<sup>142</sup> and went on to state: "[w]hat is key in determining reasonable equivalency then is whether, in exchange for the transfer, the debtor received in return the continued opportunity to financially survive, where, without the transfer, its financial demise would have been all but certain. Where such indirect economic benefits are provided, 'the debtors' net worth has been preserved, and the interests of the creditors will not have been injured by the transfer.' "<sup>143</sup> The district court further rejected as "a *per se* rule . . . that indirect benefits must be mathematically quantified,"<sup>144</sup> stating that "[a] debtor's opportunity . . . to improve its prospects of avoiding bankruptcy are precisely the kind of benefits that, by definition, are not susceptible to exact quantification but are nonetheless legally cognizable under section 548."<sup>145</sup>

The district court criticized the bankruptcy court for its retrospective analysis of reasonably equivalent value, which emphasized that TOUSA's and the Conveying Subsidiaries' bankruptcy filings took place a mere six months after the Settlement and related transactions. It warned against the hindsight review of transactions "through the lens of retrospection to point out that bankruptcy ultimately was not avoided . . . [W]hether a debtor

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<sup>141</sup>*Id.* at 660.

<sup>142</sup>*Id.* at 656.

<sup>143</sup>*Id.* at 660–61 (quoting *Kipperman v. Onex Corp.*, 411 B.R. 805, 809 (N.D. Ga. 2009), reconsideration denied in part, 2010 WL 761227 (N.D. Ga. 2010)).

<sup>144</sup>*Id.* at 665.

<sup>145</sup>*Id.*

received reasonably equivalent value must be evaluated as of the date of the transaction.”<sup>146</sup>

i. The District Court found the Bankruptcy Court Nar-rowed the Meaning of Value in the Context of Reasonably Equivalent Value

The district court reversed the bankruptcy court’s findings on the meaning of “value” in the context of determining “reasonably equivalent value.”<sup>147</sup> Although the Bankruptcy Code does not define “reasonably equivalent value,” it does define “value,” for fraudulent transfer purposes, as “property, or satisfaction or securing of a present or antecedent debt of the debtor.”<sup>148</sup> The district court found that the bankruptcy court committed “compelling legal error” when it (a) relied on the dictionary definition of “property” to analyze whether the Conveying Subsidiaries had received value, and (b) concluded that the avoidance of default or bankruptcy did not satisfy the definition of “property,”<sup>149</sup> and therefore could not constitute value.<sup>150</sup> The district court observed that the bankruptcy court’s ruling was contrary to established

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<sup>146</sup>*Id.* at 666 (citing *In re Joy Recovery Technology Corp.*, 286 B.R. 54, 75 (Bankr. N.D. Ill. 2002)). *TOUSA II* also cited *In re R.M.L., Inc.*, 92 F.3d 139, 152, 29 Bankr. Ct. Dec. (CRR) 591, 36 Collier Bankr. Cas. 2d (MB) 498 (3d Cir. 1996) (viewing a transaction in hindsight would mean that only successful investments can confer value to a debtor, contrary to one policy reason behind § 548, which is to encourage the debtor to take “some risks that could generate value”).

<sup>147</sup>*TOUSA II*, 444 B.R. at 655.

<sup>148</sup>*Id.* (citing 11 U.S.C. § 548(d)(2)(A)).

<sup>149</sup>The district court posited that the bankruptcy court’s use of the dictionary definition of “property” was contrary even to the term’s intended meaning in the Bankruptcy Code, citing legislative history that indicates that “property” should be construed in the broadest sense. It further cited Supreme Court precedent holding that “property” is broadly and generously defined. *Id.* at 656 (citing *Segal v. Rochelle*, 382 U.S. 375, 379, 86 S. Ct. 511, 15 L. Ed. 2d 428, 66-1 U.S. Tax Cas. (CCH) P 9173, 17 A.F.T.R.2d 163 (1966); *Kokoszka v. Belford*, 417 U.S. 642, 94 S. Ct. 2431, 41 L. Ed. 2d 374, 74-2 U.S. Tax Cas. (CCH) P 9570, 34 A.F.T.R.2d 74-5196 (1974); *Perry v. Sindermann*, 408 U.S. 593, 601 (1972) (“‘[P]roperty’ denotes a broad range of interests that are secured by ‘existing rules or understandings.’ ”)); see also *Lines v. Frederick*, 400 U.S. 18, 19, 91 S. Ct. 113, 27 L. Ed. 2d 124 (1970) (same); *In re Taylor*, 386 B.R. 361, 368, 59 Collier Bankr. Cas. 2d (MB) 1267, 101 A.F.T.R.2d 2008-2332 (Bankr. S.D. Fla. 2008), *aff’d*, 402 B.R. 56, 103 A.F.T.R.2d 2009-477 (S.D. Fla. 2008) (citing *Segal* and noting that “[s]ubsequent Court of Appeals decisions have confirmed the continuing vitality of *Segal* under the Bankruptcy Code”).

<sup>150</sup>*TOUSA II*, 444 B.R. at 656. The district court noted that a bankruptcy court’s definition of a Bankruptcy Code term is subject to *de novo* review, citing

precedent recognizing that “property” is to be construed broadly and encompasses tangibles and intangibles, as well as indirect benefits, including economic benefits.<sup>151</sup>

The district court found that the bankruptcy court further erred in failing to consider the “totality of the circumstances” in measuring the reasonable equivalency of the alleged value provided to the Conveying Subsidiaries.<sup>152</sup> It opined, based on the Eleventh Circuit’s holding in *In re Duque Rodriguez*,<sup>153</sup> that “the decisive inquiry can be simplified to whether, based on the totality of the circumstances at the time of the transfer, the result was to preserve the debtor’s net worth by conferring realizable commercial value on the debtor. Otherwise stated, but for the transfer, was there a realistic risk that the Conveying Subsidiaries and the enterprise would not financially continue to survive?”<sup>154</sup> Taking into account the Trigger Clauses and the likely devastating effect an adverse judgment would have on the Conveying Subsidiaries’ financial health and survival, the district court found that the Conveying Subsidiaries did receive reasonably equivalent value under the “totality of the circumstances” test.<sup>155</sup>

In reviewing the bankruptcy court’s dismissal of the Transeastern Lenders’ argument that the Conveying Subsidiaries had received reasonably equivalent value in exchange for any minimal

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*In re Morgan*, 182 F.3d 775, 777, 34 Bankr. Ct. Dec. (CRR) 973, Bankr. L. Rep. (CCH) P 77959, 84 A.F.T.R.2d 99-5475 (11th Cir. 1999).

<sup>151</sup>*TOUSA II*, 444 B.R. at 656–57.

<sup>152</sup>*Id.* at 661. The district court examined the “totality of the circumstances” test adopted by the Third Circuit Court of Appeals in *R.M.L.* and applied in the Eleventh Circuit by district and bankruptcy courts in Florida. The *R.M.L.* test considers three factors: (i) whether the transaction was at arm’s length; (ii) whether the transferee acted in good faith; and (iii) the degree of the difference between the fair market value of the assets transferred and the price paid. *In re R.M.L., Inc.*, 92 F.3d 139, 152, 29 Bankr. Ct. Dec. (CRR) 591, 36 Collier Bankr. Cas. 2d (MB) 498 (3d Cir. 1996); *see also Wiand v. Waxenberg*, 611 F. Supp. 2d 1299 (M.D. Fla. 2009); *In re Evergreen Security, Ltd.*, 319 B.R. 245, 253 (Bankr. M.D. Fla. 2003).

<sup>153</sup>*In re Rodriguez*, 895 F.2d 725, 727, 22 Collier Bankr. Cas. 2d (MB) 633, Bankr. L. Rep. (CCH) P 73282 (11th Cir. 1990) (holding that payments that provided neither direct nor indirect benefit to debtor were avoidable as fraudulent transfers).

<sup>154</sup>*TOUSA II*, 444 B.R. at 662.

<sup>155</sup>*Id.* at 663–65.

interest<sup>156</sup> they may have had in the proceeds of the New Loan, the district court analyzed the metrics of reasonably equivalent value employed by the bankruptcy court.<sup>157</sup> The district court discussed the error implicit in the bankruptcy court's simultaneous holdings that (a) although the Conveying Subsidiaries had a minimal property interest in the New Loan proceeds sufficient to make it over the hurdle of section 548's "interest of the debtor in property" requirement, (b) they did not receive reasonably equivalent value because any minimal value received by the Conveying Subsidiaries was not equivalent to the value of the pledges made to secure the \$500 million New Loan.<sup>158</sup> Logically, the district court reasoned, if the Conveying Subsidiaries had a minimal property interest in the New Loan proceeds, then they, in turn, would only have had to receive a minimal benefit in exchange to constitute reasonably equivalent value, because "reasonably equivalent value must be measured in terms of the value of the *debtors' interest in the property conveyed*."<sup>159</sup> Thus, the district court found that such value had been provided.<sup>160</sup>

## ii. Indirect and Intangible Benefits

The district held that the bankruptcy court's determination that the indirect benefit received by the Conveying Subsidiaries

<sup>156</sup>While disregarded in *TOUSA II*, the Transeastern Lenders argued below that the Conveying Subsidiaries and TOUSA were so related such that they shared an identity of interest sufficient to establish that, when value was given to TOUSA, value was also given to the Conveying Subsidiaries and, as such, the Conveying Subsidiaries received reasonably equivalent value through the New Loan. *Id.* at 670. The "identity of interest" doctrine recognizes that where the debtor and a third party are so related that the two share an "identity of interest," then a transaction that benefits one party will necessarily inure to the benefit of the other. *Id.* at 653–54 n. 43 (quoting *In re Royal Crown Bottlers of North Alabama, Inc.*, 23 B.R. 28, 30 (Bankr. N.D. Ala. 1982)). The district court, however, did not reach the "identity of interest" issue, because it held that the record below established that the Conveying Subsidiaries received an indirect economic benefit, and therefore there was no need to address whether the benefit to TOUSA was shared by the Conveying Subsidiaries. *Id.* at 654. In so finding, the district court accepted the bankruptcy court's conclusion that, in order to demonstrate reasonably equivalent value, benefits must be received by each debtor. *Id.*

<sup>157</sup>*Id.* at 651.

<sup>158</sup>*Id.*

<sup>159</sup>*Id.* (emphasis supplied) (citing *In re Duke & Benedict, Inc.*, 265 B.R. 524, 531 (Bankr. S.D. N.Y. 2001) (noting that the relevant inquiry for analyzing reasonably equivalent value is not "the value of the property that was conveyed, but the value of the debtor's interest in the property conveyed")).

<sup>160</sup>*Id.* at 653.

had little or no value was also clearly erroneous,<sup>161</sup> and found that the bankruptcy court had impermissibly shifted the burden of proof for a lack of reasonably equivalent value under section 548(a)(1)(B)(i) from the Committee to the defendants when it found that the New Lenders and the Transeastern Lenders had “failed to carry the burden of producing evidence of indirect benefits that were tangible and concrete, and quantifying the value of those benefits with reasonable precision.”<sup>162</sup> It further chastised the bankruptcy court for ignoring well-established precedent holding that indirect value includes both tangible and intangible benefits.<sup>163</sup> In finding that the Conveying Subsidiaries had not received reasonably equivalent value, the bankruptcy court stated that “value” under section 548 of the Bankruptcy Code does not include “benefits,” direct or indirect, and determined that any purported indirect value provided by the defendants was legally irrelevant.<sup>164</sup> Citing precedent from the Supreme Court and other circuit courts, the district court emphasized that economic benefits, including indirect benefits, may be considered in assessing value.<sup>165</sup> Further, the district court found that the bankruptcy court ignored Eleventh Circuit precedent holding that section 548(a)(1) “does not authorize voiding a transfer which confers an economic benefit upon the debtor,

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<sup>161</sup>*Id.* at 667–70.

<sup>162</sup>*Id.* at 653.

<sup>163</sup>*Id.* at 657.

<sup>164</sup>*TOUSA I*, 422 B.R. at 868.

<sup>165</sup>*TOUSA II*, 444 B.R. at 657 (citing *In re Hannover Corp.*, 310 F.3d at 801 (“holding that the ‘arc of § 548 easily encompasses as ‘value’ an exchange of cash for a right to buy or sell property at a future point in time’ ”); *In re Young*, 82 F.3d 1407, 1415, 36 Collier Bankr. Cas. 2d (MB) 163 (8th Cir. 1996); (“holding that the district court correctly ‘did not define ‘value’ only in terms of tangible property or marketable financial value’ ”) *Cordes & Co., LLC v. Mitchell Companies, LLC*, 605 F. Supp. 2d 1015, 1022 (N.D. Ill. 2009) (“ ‘Indirect benefits can include a wide range of intangibles.’ ”); *In re Jumer’s Castle Lodge, Inc.*, 338 B.R. 344, 354, Bankr. L. Rep. (CCH) P 80469 (C.D. Ill. 2006), *aff’d*, 472 F.3d 943, 47 Bankr. Ct. Dec. (CRR) 146, Bankr. L. Rep. (CCH) P 80830 (7th Cir. 2007) (“ ‘[I]ndirect benefits constitute ‘value’ and can include a wide range of intangibles such as: corporation’s goodwill or increased ability to borrow working capital; the general relationship between affiliates or ‘synergy’ within a corporate group as a whole; and a corporation’s ability to retain an important source of supply or an important customer’ ”)).



either directly or indirectly,”<sup>166</sup> and noted that the Eleventh Circuit’s ruling in *In re Duque Rodriguez* recognized that a debtor’s reprieve from foreclosure, which allowed the debtor to continue as a going concern, could be considered an indirect economic benefit and, thus, “value” under section 548 of the Bankruptcy Code.<sup>167</sup>

b. Ordering Recovery from the Transeastern Lenders  
Under Section 550(a)(1) of the Bankruptcy Code

In ordering disgorgement of the proceeds of the New Loan, the bankruptcy court in held that the Transeastern Lenders, as the ultimate beneficiaries of the liens granted by the Conveying Subsidiaries, were liable under section 550(a)(1) of the Bankruptcy Code<sup>168</sup> as both (i) direct transferees of the New Loan proceeds<sup>169</sup> and (ii) entities “for whose benefit” the Conveying Subsidiaries transferred the liens to the New Lenders.<sup>170</sup> The district court reversed these holdings.

i. Whether the Transeastern Lenders Were Direct Transferees

The Transeastern Lenders argued that the “direct transfer” theory of liability employed by the bankruptcy court was flawed because avoidance under section 548 of the Bankruptcy Code, the predicate for recovery under section 550(a) of the Bankruptcy Code, is based upon “a transfer of an interest of the debtor in property.” They maintained that such a transfer did not occur when the Transeastern Lenders received the New Loan proceeds

<sup>166</sup>*TOUSA II*, 444 B.R. at 657 (quoting *In re Rodriguez*, 895 F.2d 725, 727, 22 Collier Bankr. Cas. 2d (MB) 633, Bankr. L. Rep. (CCH) P 73282 (11th Cir. 1990)).

<sup>167</sup>*Id.* at 658. The debtor in *In re Duque Rodriguez* made payments on a subsidiary’s aircraft loan. The Eleventh Circuit, in avoiding the transfers, found that the debtor did not benefit, either directly or indirectly, from such payments. 895 F.2d at 729.

<sup>168</sup>Section 550(a) of the Bankruptcy Code, in relevant part, provides: “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) . . . , 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: (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or (2) any immediate or mediate transferee of such initial transferee.” 11 U.S.C. § 550(a); see section II.B. of this article for a general description of section 550(a) of the Bankruptcy Code and its background.

<sup>169</sup>*TOUSA II*, 444 B.R. at 645.

<sup>170</sup>*Id.*; see also *TOUSA I*, 422 B.R. at 870, 881, 884.

because the Conveying Subsidiaries did not have a property interest in the proceeds and thus transferred nothing to the Transeastern Lenders.<sup>171</sup> The district court agreed, noting that in order to have an “interest in property,” a debtor must actually have control over the property.<sup>172</sup> Since the agreements governing the New Loan required that the proceeds be immediately used to pay the Settlement amount to the Transeastern Lenders, the Conveying Subsidiaries never had possession of or control over the funds, nor the ability to direct how the funds should be used. Thus, since the Conveying Subsidiaries did not have a property interest in the New Loan proceeds, the district court held that the transfer of proceeds was not avoidable under a “direct transfer” theory.<sup>173</sup>

ii. The District Court Found the Transfers Subject to Avoidance Were Not for the Benefit of the Transeastern Lenders

The bankruptcy court also held that the Transeastern Lenders were liable under section 550(a) of the Bankruptcy Code as entities “for whose benefit” the Conveying Subsidiaries transferred liens to the New Lenders because the liens collateralized the New Loan, the proceeds of which were used to satisfy TOUSA’s debt to the Transeastern Lenders.<sup>174</sup> The district court, however, rejected this ruling,<sup>175</sup> and held that the Transeastern Lenders were not entities from whom the transfer could be recovered because the Transeastern Lenders did not receive the liens, only the New Loan proceeds.<sup>176</sup> Further, the district court clarified that recovery from the Transeastern Lenders was inappropriate because the transfer of the New Loan proceeds was not a direct

<sup>171</sup>*TOUSA II*, 444 B.R. at 646; see also 11 U.S.C. § 548(a)(1).

<sup>172</sup>*TOUSA II*, 444 B.R. at 646–48 (citing *In re Chase & Sanborn Corp.*, 848 F.2d 1196, 1199, Bankr. L. Rep. (CCH) P 72363 (11th Cir. 1988) and *In re Chase & Sanborn Corp.*, 813 F.2d 1177, 1181–82, Bankr. L. Rep. (CCH) P 71753 (11th Cir. 1987)). The district court later found that the initial transfer avoided for purposes of section 550 was the transfer of the liens to the New Lenders, who had complete control over those liens. *Id.* at 672.

<sup>173</sup>*Id.* at 646–48. This definition of property may be narrower than the definition relied upon by the district court to find that the Transeastern Lenders had provided “reasonably equivalent value.” See *supra* at note 149.

<sup>174</sup>*TOUSA II*, 444 B.R. at 670.

<sup>175</sup>Notably, the district court cited the 2010 edition of this article, observing that section 550(a)(1) did not initially embody the ability to recover from the entity for whose benefit such transfer was made. See *id.* at 676.

<sup>176</sup>*Id.* at 672. The district court was careful to parse the trial testimony to determine exactly which transfer was at issue with respect to § 550(a)(1) of the Bankruptcy Code’s “such transfer” language, determining that the relevant

consequence of the transfer of liens to the New Lenders.<sup>177</sup> The district court took care to visit this issue, even as it acknowledged that its decision on this issue was unnecessary in light of its other rulings on reasonably equivalent value and related issues.<sup>178</sup>

The district court found that the bankruptcy court's interpretation of section 550(a)(1)'s "for whose benefit such transfer was made" language (a) was "overly broad" and (b) neglected to analyze the specific text of the provision.<sup>179</sup> Put simply, section 550(a) of the Bankruptcy Code allows recovery from (1) an initial transferee, (2) an entity for whose benefit the initial transfer was made, or (3) a subsequent transferee.<sup>180</sup> The district court reiterated that, under the Eleventh Circuit's "control" test,<sup>181</sup> the New Lenders, rather than the Transeastern Lenders, were the initial transferees of the liens granted by the Conveying Subsidiaries, because they received the benefit of those liens.<sup>182</sup> Because the New Lenders were the initial transferees, the Transeastern Lend-

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transfer was the transfer of liens to the New Lenders rather than the transfer of proceeds to the Transeastern Lenders. *Id.*

<sup>177</sup>*Id.* at 674.

<sup>178</sup>*Id.* at 670. The district court noted that it need not rule on this issue due to its finding that the Conveying Subsidiaries had received reasonably equivalent value for purposes of section 548(a)(1)(B) of the Bankruptcy Code. However, it reversed the bankruptcy court's ruling as clearly erroneous in order to preserve its result should the Eleventh Circuit sustain the bankruptcy court's rulings on reasonably equivalent value. *Id.* The Eleventh Circuit did so in *TOUSA III*. See *In re TOUSA, Inc.*, 680 F.3d 1298, 56 Bankr. Ct. Dec. (CRR) 135 (11th Cir. 2012).

<sup>179</sup>*TOUSA II*, 444 B.R. at 671. As further support, the district court quoted several cases providing that the paradigm of an entity "for whose benefit such transfer" is made is a guarantor of a debtor, and observed that the Transeastern Lenders clearly did not fit this mold because they were not guarantors of the debtor Conveying Subsidiaries. *Id.*

<sup>180</sup>*Id.*

<sup>181</sup>*Id.* at 672 (quoting *In re Pony Exp. Delivery Services, Inc.*, 440 F.3d 1296, 1300, 46 Bankr. Ct. Dec. (CRR) 24, Bankr. L. Rep. (CCH) P 80465 (11th Cir. 2006) (holding that an insurance broker who merely held a debtor's deposit to cover insurance premiums was not an initial transferee)). "[A] recipient of an avoidable transfer is an initial transferee only if they exercise legal control over the assets received, such that they have the right to use the assets for their own purposes, and not if they merely served as a conduit for assets that were under the actual control of the debtor-transferor or the real initial transferee." 440 F.3d at 1300.

<sup>182</sup>*TOUSA II*, 444 B.R. at 673.

ers could only be, at most, subsequent transferees.<sup>183</sup> However, the district court noted that since the liens remained with the New Lenders and were never transferred to the Transeastern Lenders, the Transeastern Lenders were not subsequent transferees of the liens.<sup>184</sup> The district court determined that for purposes of ordering recovery from the Transeastern Lenders, bankruptcy court mistakenly concluded that the Transeastern Lenders were both initial transferees and entities for whose benefit such transfers were made. This mistaken conclusion was based upon the bankruptcy court's incorrect characterization of the series of transactions that led to the payment of the New Loan proceeds to the Transeastern Lenders as a "single integrated transaction, rather than a series of separate transactions."<sup>185</sup> As the district court pointed out, not only was consolidating the transactions contrary to the bankruptcy court's analysis of the various transactions under section 548 of the Bankruptcy Code—where the bankruptcy court did break down the transfers—but it was also unsupported by the documents underlying the transactions, which made clear that the various transactions made in connection with the New Loans were, in fact, separate.<sup>186</sup>

iii. The District Court Determined the Transeastern Lenders Were Subsequent Transferees Who Could Not be Liable as Entities for Whose Benefit the Transfer Was Made

The district court in *TOUSA II* also found that the bankruptcy court further erred by relying on the "for whose benefit" language without considering whether the Transeastern Lenders were subsequent transferees.<sup>187</sup> The district court observed that because "the structure of the statute separates the initial transferees and beneficiaries of initial transfers, on the one hand, from 'immediate or mediate transferee[s]' on the other," section 550(a) of the Bankruptcy Code links the initial transferee with

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<sup>183</sup>*Id.* The district court explained that while the liability of "an initial transferee[] or an entity for whose benefit the initial transfer was made is absolute . . . the liability of the subsequent transferee to the estate is not strict but subject to the 'good faith purchaser for value' defense contained in § 550(b)." *Id.* at 671. The bankruptcy court did not find that the Transeastern Lenders were either initial or subsequent transferees of the liens securing the New Loans. *Id.* at 672.

<sup>184</sup>*Id.*

<sup>185</sup>*Id.*

<sup>186</sup>*Id.*

<sup>187</sup>*Id.* at 674.

the entity for “whose benefit” the initial transfer was made, such that “only a person (or entity) who receives a benefit from the *initial* transfer” can be an entity “for whose benefit” the initial transfer was made.<sup>188</sup> Therefore, the Transeastern Lenders were not entities “for whose benefit” the transfer was made, because “a subsequent transferee cannot be the ‘entity for whose benefit’ the initial transfer was made.”<sup>189</sup> The district court also clarified that the “for whose benefit” language does not apply where the benefit is not the immediate and necessary consequence of the initial transfer, but instead is a result of the transfer’s use by its recipient.<sup>190</sup> Because the Transeastern Lenders were “subsequent transferees” of the proceeds of the New Loan secured by the liens, the Transeastern Lenders did not qualify as “entities for whose benefit” the transfers were made pursuant to section 550(a)(1) of the Bankruptcy Code. Thus, the district court found that the Transeastern Lenders were too far removed from the transfer of liens by the Conveying Subsidiaries to be strictly liable as initial transferees for a fraudulent transfer under section 550(a) of the Bankruptcy Code.<sup>191</sup>

iv. As Subsequent Transferees the Transeastern Lenders Were Protected Under Section 550(b) of the Bankruptcy Code

The district court observed the bankruptcy court erroneously found the Transeastern Lenders strictly liable without consider-

<sup>188</sup> *Id.* (emphasis supplied).

<sup>189</sup> *Id.* (citing *In re Southeast Hotel Properties Ltd. Partnership*, 99 F.3d 151, 155, 29 Bankr. Ct. Dec. (CRR) 1202, 36 Collier Bankr. Cas. 2d (MB) 1649, Bankr. L. Rep. (CCH) P 77158 (4th Cir. 1996); *Bonded Financial Services, Inc. v. European American Bank*, 838 F.2d 890, 897, 17 Bankr. Ct. Dec. (CRR) 299, 18 Collier Bankr. Cas. 2d (MB) 155 (7th Cir. 1988) (an entity “for whose benefit” a transfer was made cannot be a subsequent transferee); *Lippi v. City Bank*, 955 F.2d 599, 611 (9th Cir. 1992) (same); *In re Bullion Reserve of North America*, 922 F.2d 544, 548, 21 Bankr. Ct. Dec. (CRR) 326, 24 Collier Bankr. Cas. 2d (MB) 698, Bankr. L. Rep. (CCH) P 73771 (9th Cir. 1991) (noting that a subsequent transferee cannot be an entity for whose benefit the initial transfer was made, even if the subsequent transferee actually receives a benefit from the initial transfer); *In re Columbia Data Products, Inc.*, 892 F.2d 26, 28, 19 Bankr. Ct. Dec. (CRR) 1799, Bankr. L. Rep. (CCH) P 73106 (4th Cir. 1989) (same); *In re Universal Clearing House Co.*, 62 B.R. 118, 128 n.12 (D. Utah 1986) (“A reading of subsection (a)(1) in conjunction with the remainder of section 550 leads to the conclusion that the phrase ‘or the entity for whose benefit such transfer was made’ refers to those who receive a benefit as a result of the initial transfer from the debtor—not as the result of a subsequent transfer”).

<sup>190</sup> *TOUSA II*, 444 B.R. at 674.

<sup>191</sup> *Id.*



ing the possibility that the transfers of the proceeds of the New Loan to the Transeastern Lenders were not recoverable under section 550(a)(2) by virtue of the defense to liability provided in section 550(b) of the Bankruptcy Code,<sup>192</sup> which “precludes recovery from a subsequent transferee that takes for value, including satisfaction . . . of a[n] . . . antecedent debt in good faith” and without knowledge of the voidability of the transfer,<sup>193</sup> as the Transeastern Lenders took the New Loan proceeds for value, in satisfaction of a valid antecedent debt.<sup>194</sup> Refusing to remand on this issue, the district court noted that section 550(b) does not require that value supplied by the subsequent transferee be provided to the debtor and found that the satisfaction of TOUSA’s valid antecedent debt satisfied the value prong of section 550(b).<sup>195</sup> The district court also found that the Committee had offered no evidence establishing (a) that the Transeastern Lenders acted in bad faith in entering into the Settlement, or (b) accepted repayment on their valid antecedent debt with knowledge of the voidability of the transfer to the New Lenders, notwithstanding the bankruptcy court’s finding that the Transeastern Lenders acted in bad faith because they knew or should have known on the basis of publically available information that TOUSA and the Conveying Subsidiaries were insolvent or close to being insolvent at the time of the Settlement.<sup>196</sup>

In reversing the bankruptcy court on this particular holding, the district court found that such a ruling “impose[d] extraordinary duties of due diligence on the part of creditors accepting repayment duties that equal or exceed those imposed on lenders extending credit in the first place. To the contrary, the district court found that the Transeastern Lenders, as recipients of a debt payment, had no reason or legal duty to conduct such extraordinary due diligence with respect to the provenance of the funds with which they were being repaid.”<sup>197</sup>

In concluding, the district court chastised the bankruptcy court

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<sup>192</sup>11 U.S.C. § 550(b). See section II.B. of this article for the language of and background on section 550(b).

<sup>193</sup>*TOUSA II*, 444 B.R. at 674. There was no question that the payment of the undisputed antecedent debt owed to the Transeastern Lenders satisfied the value requirement of § 550(b) as such value need not be to the debtor. *Id.* at 674–75.

<sup>194</sup>*Id.*

<sup>195</sup>*Id.* at 675.

<sup>196</sup>*Id.* at 675.

<sup>197</sup>*Id.* at 675–76.

for finding, without pointing to any evidentiary support, that the Transeastern Lenders acted in bad faith and were grossly negligent because they (a) knew or should have known that TOUSA and its subsidiaries were insolvent when they entered into the New Loan transactions, and (b) should have examined the debtors' financial structure to ascertain that the Conveying Subsidiaries were to receive reasonably equivalent value as a result of the transactions.<sup>198</sup> The district court distilled the bankruptcy court's ruling in regard to the Transeastern Lenders as "it is 'bad faith' for a creditor of someone *other than the debtor* to accept payment of a valid, tendered debt repayment outside of any preference period, through settlement or otherwise, if the creditor does not first investigate the debtor's internal re-financing structure and ensure that the debtor's subsidiaries had received fair value as part of the repayment, or that the debtor and its subsidiaries, in an enterprise, were not insolvent or precariously close to being insolvent."<sup>199</sup> The district court criticized the exhaustive duties such an expansion of the requirements of section 550 of the Bankruptcy Code would impose on banks and other creditors, stating that such a finding is "patently unreasonable and unworkable," would vastly expand the duties of subsequent transferees, and is not supported by applicable bankruptcy and non-bankruptcy law.<sup>200</sup>

#### 4. *TOUSA III—A Return to Liability for Transeastern Lenders*

The Committee appealed the *TOUSA II* decision to the Eleventh Circuit Court of Appeals, and the New Lenders' related appeals of the bankruptcy court's ruling to the district court that were pending at the time of the *TOUSA II* decision were stayed pending the determination by the Eleventh Circuit.<sup>201</sup> On appeal, the Committee sought reversal of *TOUSA II* and affirmance of the bankruptcy court's determinations that (a) the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for the transfers to the New Lenders, and (b) the Transeastern Lenders are entities for whose benefit the transfers were made. The Committee further argued that the case should be remanded to the district court, and consolidated with the ap-

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<sup>198</sup> *Id.* at 675.

<sup>199</sup> *Id.*

<sup>200</sup> *Id.*

<sup>201</sup> See Order Staying and Administratively Closing Case, Wells Fargo Bank, NA v. Official Committee of Unsecured Creditors, No. 10-cv-60018 (S.D. Fla. March 28, 2011).

peals of the New Lenders that are pending before Judge Aldaberto Jordan, while the Transeastern Lenders argued on appeal that the remedies ordered by the bankruptcy court should be vacated.<sup>202</sup>

Reviewing findings of fact for clear error, the determinations of law de novo and equitable determinations for abuse of discretion, the Eleventh Circuit agreed with the Committee that the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for their liens, held that the Transeastern Lenders were entities for whose benefit the liens were transferred, and remanded to the district court the issues of judicial assignment and consolidation raised by the parties.<sup>203</sup> In addition, the Eleventh Circuit refused to address the arguments raised by the Transeastern Lenders regarding the remedies ordered by the bankruptcy court, because such issues had not been considered by the district court.<sup>204</sup> These issues were also remanded to the district court.

Regarding the question of whether the Conveying Subsidiaries had received reasonably equivalent value, the Eleventh Circuit found that the bankruptcy court did not clearly err when it found that the Conveying Subsidiaries did not receive reasonably equivalent value when they conveyed the liens to the New Lenders.<sup>205</sup> In so finding, the Eleventh Circuit stated that it need not address the question of whether the bankruptcy court erred when it adapted a narrow definition of “value,” because the record supports the bankruptcy court’s conclusion that, whether or not the avoidance of bankruptcy constituted value to the Conveying Subsidiaries, any value provided to the Conveying Subsidiaries was far outweighed by the costs of the transactions at issue.<sup>206</sup> In support of this holding, the Eleventh Circuit pointed to the bankruptcy court’s conclusion that, even if all of the TOUSA entities would have immediately collapsed into bankruptcy but for the

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<sup>202</sup>See Committee Brief and Committee Reply Brief, *Senior Transeastern Lenders v. Official Comm. of Unsecured Creditors*, No. 11-11071 (11th Cir., May 6, 2011 and June 18, 2011). As noted *supra* at note 103, certain of the parties entered into a partial settlement that resolves some economic issues but provided for the completion of the appeal to the Eleventh Circuit.

<sup>203</sup>*In re TOUSA, Inc.*, 680 F.3d 1298, 56 Bankr. Ct. Dec. (CRR) 135 (11th Cir. 2012).

<sup>204</sup>*TOUSA*, 680 F.3d 1298 (citing *In re Prudential of Florida Leasing, Inc.*, 478 F.3d 1291, 1303, 47 Bankr. Ct. Dec. (CRR) 212, 57 Collier Bankr. Cas. 2d (MB) 684, Bankr. L. Rep. (CCH) P 80852 (11th Cir. 2007)).

<sup>205</sup>*Id.* at \*12–14.

<sup>206</sup>*Id.* at \*12.

Settlement, the Settlement and related transactions were “*still* the more harmful option.”<sup>207</sup> The Eleventh Circuit dismissed the Transeastern Lenders and New Lenders’ arguments that such a conclusion was unsupportable, stating that the weight of the evidence available at the time of the Settlement demonstrated that, due to the economic climate in the homebuilding industry, as well as TOUSA’s internal financial weaknesses, the bankruptcies of the TOUSA entities were inevitable.<sup>208</sup>

In addressing the issue of whether the Transeastern Lenders were entities from whom recovery could be ordered under section 550(a)(1) of the Bankruptcy Code, the Eleventh Circuit found that the plain language of the statute, combined with the language of the documents governing the New Loan, supported the conclusion that the Transeastern Lenders were entities “for whose benefit” the Conveying Subsidiaries transferred the liens.<sup>209</sup> In so holding, the Eleventh Circuit relied on its decision in *In re Air Conditioning*,<sup>210</sup> where the circuit found that a trustee could recover from the creditor of a company the value of the security posted to secure a letter of credit issued to the creditor on behalf of the debtor.<sup>211</sup> The reasoning behind *Air Conditioning* was that the transfer of the collateral to the bank that issued the letter of credit was a voidable preference because it enabled the creditor to receive more value than it would have in liquidation, and that the creditor was the entity for whose benefit the transfer was made because the creditor, rather than the issuer, received the benefit of the transfer in the form of the letter of credit.<sup>212</sup> The Eleventh Circuit reasoned in *TOUSA III* that the Conveying Subsidiaries were in a position analogous to that of the creditor in *Air Conditioning*, and rejected the Transeastern Lenders’ arguments that *Air Conditioning* was distinguishable because the *TOUSA* case did not involve an avoidable preference or a letter of credit.<sup>213</sup>

The Eleventh Circuit also rejected the Transeastern Lenders’

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<sup>207</sup>*Id.* at \*13 (citing *TOUSA I*, 422 B.R. at 847 (emphasis supplied)).

<sup>208</sup>*Id.* at \*13–14.

<sup>209</sup>*Id.* at \*14.

<sup>210</sup>*In re Air Conditioning, Inc. of Stuart*, 845 F.2d 293, 17 Bankr. Ct. Dec. (CRR) 1385, 18 Collier Bankr. Cas. 2d (MB) 973, Bankr. L. Rep. (CCH) P 72302 (11th Cir. 1988).

<sup>211</sup>*Id.* at 299.

<sup>212</sup>*Id.*

<sup>213</sup>*In re TOUSA, Inc.*, 680 F.3d 1298, 56 Bankr. Ct. Dec. (CRR) 135 (11th Cir. 2012).

argument that they could not be liable under section 550(a)(1) because they were not the initial transferees of the Conveying Subsidiaries' liens, but rather only benefitted from the subsequent transfer of funds from TOUSA.<sup>214</sup> The circuit emphasized that because the documents governing the New Loan required that the proceeds be used to pay the Settlement, it did not matter that the funds passed through a TOUSA subsidiary before they were wired to the Transeastern Lenders. Under the terms of the New Loan documents, the subsidiary never had control over the funds.<sup>215</sup> In response to the Transeastern Lenders' argument that such a ruling would impose "extraordinary" duties on creditors accepting repayment, the circuit court noted that "[i]t is far from a drastic obligation to expect some diligence from a creditor when it is being repaid hundreds of millions of dollars by someone other than its debtor."<sup>216</sup>

While *TOUSA II* provided a brief breathing spell for lenders, *TOUSA III's* affirmance of the bankruptcy court's opinion reinstates, at least in the Eleventh Circuit, duties on lenders to investigate a borrower's financial condition during repayment perhaps more stringently than they would when underwriting a new loan.

## **B. Reasonably Equivalent Value and Good Faith in Ponzi Schemes**

Some of the most interesting decisions related to fraudulent transfer law in 2011 were borne out of the fertile ground of Ponzi schemes.<sup>217</sup> The multibillion-dollar Ponzi scheme orchestrated by Bernard L. Madoff ("Madoff") as well as other recent Ponzi

<sup>214</sup>*TOUSA*, 680 F.3d 1298.

<sup>215</sup>*Id.* (citing *In re Chase & Sanborn Corp.*, 848 F.2d 1196, 1199, Bankr. L. Rep. (CCH) P 72363 (11th Cir. 1988) (stating that courts must apply a "very flexible, pragmatic" test that "look[s] beyond the particular transfers in question to the entire circumstance of the transactions" when deciding whether debtors had controlled property later sought by their trustees); *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) (holding that a bank was not an initial transferee because it held funds "only for the purpose of fulfilling an instruction to make the funds available to someone else")).

<sup>216</sup>*Id.*

<sup>217</sup>A Ponzi scheme is an investment scheme that is not supported by a legitimate underlying business venture. Early investors are paid profits from the monies provided by new investors. Usually investors in the scheme are promised large returns on their principal investments. Initial investors are often paid sizable promised returns. This attracts additional investors. More and more inves-



schemes<sup>218</sup> have resulted in a plethora of avoidance actions and numerous remarkable decisions.

Ponzi scheme cases are typically about unraveling the scheme and recovering assets for redistribution to investors and creditors. Recent litigation reveals the tension between prosecutors, trustees, creditors, innocent investors and investors who arguably knew or should have known of the scheme, and some of the inconsistencies in securities laws and bankruptcy laws. 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 2011 in this area of law<sup>219</sup> are decisions recently issued by the Eleventh Circuit Court of Appeals in

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tors 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. See *Balaber-Strauss v. Lawrence*, 264 B.R. 303, 305–06, 46 Collier Bankr. Cas. 2d (MB) 851 (S.D. N.Y. 2001).

<sup>218</sup>Other recently exposed Ponzi schemes include those perpetrated by: George Lindell (see Harry Eager, Mortgage Store Owners Agree to Pay \$6 million, *The Maui News* (January 20, 2012)); David Nilsen (see Larry Parsons, Cedar Funding Owner David Nilsen Pleads Guilty to Fraud, *Monterey Herald*, October 25, 2011, [http://www.montereyherald.com/ci\\_19187759?source=most\\_viewed](http://www.montereyherald.com/ci_19187759?source=most_viewed) (last visited April 24, 2012)); Lloyd Kimura (see Harry Eagar, Judge Imposes 20 years in Kimura Ponzi Scheme, *The Maui News* (August 5, 2011)); 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 Journal*, June 10, 2010, <http://online.wsj.com/article/SB10001424052748704575304575296662423872880.html?dbk> (last visited April 24, 2012)); Marc Drier (see Benjamin Weiser, Lawyer Pleads Guilty in \$400 Million Fraud, *N.Y. Times*, May 11, 2009, [http://www.nytimes.com/2009/05/12/n\\_yregion/12dreier.html](http://www.nytimes.com/2009/05/12/n_yregion/12dreier.html) (last visited April 24, 2012)); Tom Petters (see 50-Year Term for Minnesota Man in \$3.7 Billion Ponzi Fraud, *N.Y. Times*, April 8, 2009, <http://www.nytimes.com/2010/04/09/business/09ponzi.html> (last visited April 24, 2012)); 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> (last visited April 24, 2012)).

<sup>219</sup>Several significant decisions issued this year in the Ponzi scheme area touched on several topics related to sections 548 and 550 of the Bankruptcy Code that are not discussed at length in this article, such as the safe harbor provided under section 546(e) of the Bankruptcy Code, withdrawal of the reference from the bankruptcy court to the district court, satisfaction of pleading

*Perkins v. Haines*,<sup>220</sup> and by the District Court for the Southern District of New York in the liquidation proceedings of Bernard L. Madoff Investment Securities LLC (“BLMIS”) in the adversary cases of *Picard v. Katz*<sup>221</sup> and *Picard v. Merkin*.<sup>222</sup>

The Eleventh Circuit, in *Haines*,<sup>223</sup> held that investors in a Ponzi scheme are entitled to rely upon the affirmative defense provided in section 548(c) of the Bankruptcy Code for payments made in redemption of their principal, finding that the investors took “for value and in good faith” when they received payments in redemption of the principal amount of their equity

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standards for purposes of motions to dismiss, and the standing of SIPA trustees to assert creditors’ causes of action pursuant to § 544 of the Bankruptcy Code and common law causes of action. *See, e.g., Picard v. Katz*, 462 B.R. 447, 55 Bankr. Ct. Dec. (CRR) 133, Bankr. L. Rep. (CCH) P 82077 (S.D. N.Y. 2011), motion to certify appeal denied, 466 B.R. 208, 55 Bankr. Ct. Dec. (CRR) 266 (S.D. N.Y. 2012) (§ 546(e) safe harbor); *Picard v. Flinn Investments, LLC*, 463 B.R. 280 (S.D. N.Y. 2011) (withdrawal of reference); *Picard v. JPMorgan Chase & Co.*, 460 B.R. 84, 55 Bankr. Ct. Dec. (CRR) 201, 66 Collier Bankr. Cas. 2d (MB) 1208 (S.D. N.Y. 2011) (SIPA trustee standing to bring actions on behalf of customers against Madoff’s banks for aiding and abetting fraud and breach of fiduciary duty); *Picard v. HSBC Bank PLC*, 454 B.R. 25, 55 Bankr. Ct. Dec. (CRR) 58 (S.D. N.Y. 2011), opinion amended, 2011 WL 3477177 (S.D. N.Y. 2011) (SIPA trustee’s standing to assert common law claims on behalf of customers of defunct brokerage firm against third parties); *Picard v. HSBC Bank PLC*, 450 B.R. 406, Fed. Sec. L. Rep. (CCH) P 96302 (S.D. N.Y. 2011) (withdrawal of reference); *Securities Investor Protection Corp. v. Bernard L. Madoff Inv. Securities LLC*, 454 B.R. 307 (S.D. N.Y. 2011) (withdrawal of reference); *In re Fairfield Sentry Ltd. Litigation*, 458 B.R. 665 (S.D. N.Y. 2011) (bankruptcy court jurisdiction in Chapter 15 case); *Picard v. Katz*, 2011 WL 7267859 (S.D. N.Y. 2011) (withdrawal of reference); *In re Bernard L. Madoff Inv. Securities LLC*, 458 B.R. 87, 55 Bankr. Ct. Dec. (CRR) 139 (Bankr. S.D. N.Y. 2011), leave to appeal denied, 464 B.R. 578 (S.D. N.Y. 2011) (pleading standards for, among other things, avoidance claims).

<sup>220</sup>*Perkins v. Haines*, 661 F.3d 623, 55 Bankr. Ct. Dec. (CRR) 166, Bankr. L. Rep. (CCH) P 82094 (11th Cir. 2011) (“*Haines*”).

<sup>221</sup>*Picard v. Katz*, 462 B.R. 447, 55 Bankr. Ct. Dec. (CRR) 133, Bankr. L. Rep. (CCH) P 82077 (S.D. N.Y. 2011), motion to certify appeal denied, 466 B.R. 208, 55 Bankr. Ct. Dec. (CRR) 266 (S.D. N.Y. 2012).

<sup>222</sup>*In re Bernard L. Madoff Inv. Securities LLC*, 2011 WL 3897970 (S.D. N.Y. 2011) (“*Merkin II*”) (denying defendants leave to appeal the bankruptcy court’s decision in *In re Bernard L. Madoff Inv. Securities, LLC*, 440 B.R. 243, 53 Bankr. Ct. Dec. (CRR) 268, 64 Collier Bankr. Cas. 2d (MB) 957 (Bankr. S.D. N.Y. 2010), leave to appeal denied, 2011 WL 3897970 (S.D. N.Y. 2011)). A decision from the liquidation of Dreier LLP is also significant, but not fully addressed in this article. *See In re Dreier LLP*, 452 B.R. 391 (Bankr. S.D. N.Y. 2011).

<sup>223</sup>*Perkins v. Haines*, 661 F.3d 623, 55 Bankr. Ct. Dec. (CRR) 166, Bankr. L. Rep. (CCH) P 82094 (11th Cir. 2011).

interests in the debtor through which the scheme operated.<sup>224</sup> The standard applicable to the “good faith” defense of section 548(c) for recipients of transfers from Ponzi schemes continues to be an area of substantial controversy.<sup>225</sup> In 2011, that standard was addressed by two different district court judges in avoidance actions pending in the liquidation proceedings of BLMIS<sup>226</sup> in *Merkin II*<sup>227</sup>

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<sup>224</sup>*Id.* Proposed legislation, which appears to have stalled at the House Committee on Financial Services, could potentially limit the power of court-appointed trustees marshalling assets of bankrupt brokerages, 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 would amend SIPA to 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.

<sup>225</sup>This issue was the focus of the *Bayou IV* and *Merkin I* decisions. See Gallagher, *supra* note 24, at section III.A. for a discussion of the cases of *In re Bayou Group, LLC*, 439 B.R. 284 (S.D. N.Y. 2010) (reversing a bankruptcy court ruling lowering the level of knowledge required to bar Ponzi scheme investors from relying on the “good faith” defense by holding that investors who received redemption payments are denied the defense if they were aware of “some infirmity” in the Ponzi scheme entity (i.e. a subjective test); the district court held that the applicable standard was whether the red flags raised would have put a “reasonable hedge fund investor” on inquiry notice of the company’s fraudulent scheme (i.e. an objective test)) and *Merkin I* (holding, inter alia, that a determination on the “good faith” defense in Ponzi scheme was premature when ruling on motion to dismiss that defendants might not be entitled to assert restitution claims as “reasonably equivalent value,” and that it was premature to rule on defendant’s defense that transfers were sheltered by safe harbor of section 546(e), but indicating safe harbor might not apply where no securities transfers took place). Following a trial in the *Bayou* case, the district court ruled, pursuant to a jury verdict, that the defendants had failed to prove, by a preponderance of the evidence, that they were not aware of information that would have put a “reasonable hedge fund investor” on inquiry notice of the funds’ fraudulent purpose or that the defendants performed a diligent investigation (or, alternatively, that such diligent investigation would not have turned up evidence of the fraud), perhaps rendering illusory the objective standard of *Bayou IV*. See Memorandum Opinion and Order, *In re Bayou Grp., LLC*, No. 09-cv-02340 (S.D.N.Y. Feb. 6, 2012). On February 6, 2012, the district court denied the defendants’ motion for judgment as a matter of law seeking reversal of the jury’s verdict. *Id.*

<sup>226</sup>The liquidation proceedings of BLMIS are pending in *In re Bernard L. Madoff Inv. Sec. LLC*, Bankr. S.D.N.Y. No. 08-01789 (BRL). BLMIS is being liquidated pursuant to the Securities Investor Protection Act (“SIPA”), 14 U.S.C. §§ 78aaa et seq. Congress enacted 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, 52 Bankr. Ct. Dec. (CRR) 236, Bankr. L. Rep. (CCH) P 81726 (Bankr.

and *Picard v. Katz*,<sup>228</sup> respectively—and it appears that there is a shift away from the objective standard for analyzing the good faith affirmative defense in Ponzi scheme cases.<sup>229</sup> Of particular significance, the district court in *Picard v. Katz* in granting in part the defendants’ motion to dismiss<sup>230</sup> held that the safe harbor of section 546(e) sheltered constructively fraudulent transfers made to investors in the BLMIS Ponzi scheme and that payments made in redemption of investors’ principal are recoverable as fraudulent transfers only if received in bad faith, a decision that neither the bankruptcy court nor the district court was willing to make in *Merkin I* and *Merkin II*.<sup>231</sup>

1. *Perkins v. Haines*—“Good Faith” Shelters Principal Investment

The Court of Appeals for the Eleventh Circuit in *Haines* recently held, in a case of first impression in the circuit, that equity investors in a Ponzi scheme are entitled to invoke the affirmative defense of taking in “good faith” and “for value” included in section 548(c) of the Bankruptcy Code.<sup>232</sup> In *Haines*, the plan

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S.D. N.Y. 2010) (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. *Id.* at 132–33. A SIPA liquidation is essentially a bankruptcy liquidation tailored to achieve SIPA’s objectives. *Id.* at 133 (citing 15 U.S.C. § 78fff(b)).

<sup>227</sup>In re Bernard L. Madoff Inv. Securities LLC, 2011 WL 3897970 (S.D. N.Y. 2011).

<sup>228</sup>*Picard v. Katz*, 462 B.R. 447, 55 Bankr. Ct. Dec. (CRR) 133, Bankr. L. Rep. (CCH) P 82077 (S.D. N.Y. 2011), motion to certify appeal denied, 466 B.R. 208, 55 Bankr. Ct. Dec. (CRR) 266 (S.D. N.Y. 2012).

<sup>229</sup>The standard for analyzing the good faith defense set forth in section 548(c) of the Bankruptcy Code was also analyzed at length by the bankruptcy court in the Ponzi scheme bankruptcy case of Dreier LLP. *See In re Dreier LLP*, 452 B.R. 391 (Bankr. S.D. N.Y. 2011).

<sup>230</sup>*Picard v. Katz*, 462 B.R. at 453.

<sup>231</sup>*See In re Bernard L. Madoff Inv. Securities LLC*, 2011 WL 3897970, \*11 (S.D. N.Y. 2011).

<sup>232</sup>*Perkins v. Haines*, 661 F.3d 623, 55 Bankr. Ct. Dec. (CRR) 166, Bankr. L. Rep. (CCH) P 82094 (11th Cir. 2011) (affirming bankruptcy court’s denial of the plan trustee’s motion for summary judgment). *Haines* did not address the standard for analyzing “good faith” for purposes of section 548(c). It appears that the plan trustee brought only claims alleging actually fraudulent transfer and, thus, the safe harbor provided by section 546(e) was not implicated in *Haines*. *See supra* section II.A. note 38 of this article for the language of section 548(c) of the Bankruptcy Code.

trustee<sup>233</sup> for debtors that had been utilized as instruments of a Ponzi scheme commenced several actions seeking to avoid distributions made to the debtors' equity holders as actual fraudulent transfers under section 548(a)(1)(A) of the Bankruptcy Code.<sup>234</sup> The debtors were formed and purported to be operated as hedge funds and the defendants were equity investors in the funds pursuant to agreements with the debtors. During the course of the Ponzi scheme, each of the defendants received transfers that represented returns of principal and/or "profits" on those equity investments.<sup>235</sup>

Consistent with precedent from several other jurisdictions, the Eleventh Circuit observed that transfers made in furtherance of a Ponzi scheme are presumed to have been made with the intent to defraud for purposes of Bankruptcy Code sections 544 and 548, due to the fraudulent nature of the scheme itself (the "Ponzi Scheme Presumption").<sup>236</sup> However, the Eleventh Circuit noted that a good faith affirmative defense under section 548(c) may shelter those transfers to the extent that value was provided to the debtor.<sup>237</sup> The Eleventh Circuit observed that, under precedent from other jurisdictions,<sup>238</sup> defrauded investors were found to have provided value for purposes of section 548(c) to the extent of their principal investment, but such findings did not extend to payments of amounts exceeding the principal amount of their investments.<sup>239</sup> The rationale for this rule is that defrauded investors are deemed to hold fraud claims against the debtor for the

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<sup>233</sup>The plan trustee in *Haines* was appointed pursuant to the debtors' plan of liquidation. *Haines*, 661 F.3d at 625.

<sup>234</sup>The debtors in *Haines* were International Management Associates, LLC and several related entities. They were formed by Kirk Wright, who purportedly managed and operated them as hedge funds. *Id.* at 626.

<sup>235</sup>*Id.*

<sup>236</sup>*Id.* (citing *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); *Conroy v. Shott*, 363 F.2d 90, 92, 9 Ohio Misc. 117, 37 Ohio Op. 2d 328, 38 Ohio Op. 2d 157 (6th Cir. 1966); *In re World Vision Entertainment, Inc.*, 275 B.R. 641, 656 (Bankr. M.D. Fla. 2002)). A more complete description of the Ponzi Scheme Presumption can be found in note 264 of this article.

<sup>237</sup>*Haines*, 661 F.3d at 626.

<sup>238</sup>*Id.* at 627 (citing *Donell v. Kowell*, 533 F.3d 762, 770 (9th Cir. 2008); *Scholes v. Lehmann*, 56 F.3d 750, 757–58 (7th Cir. 1995); *Eby v. Ashley*, 1 F.2d 971 (C.C.A. 4th Cir. 1924)).

<sup>239</sup>*Id.* (citing *In re Hedged-Investments Associates, Inc.*, 84 F.3d 1286, 1290, 35 Collier Bankr. Cas. 2d (MB) 1424 (10th Cir. 1996)).



principal amount of their investment.<sup>240</sup> Therefore, when the principal investment amount is returned to the investor, value is provided to the debtor through satisfaction of a valid antecedent debt, i.e. the investor's fraud claim.<sup>241</sup> However, as the Eleventh Circuit recognized, the cases so holding were not directly apposite because they did not specifically address the unique situation of investors who are equity holders of the instruments of Ponzi schemes.<sup>242</sup>

The trustee in *Haines* argued that the transfers to the investors could not have been made for value because they were not made to extinguish any type of claim or debt against the debtor, relying on a line of cases holding that transfers to redeem equity investments in insolvent entities, including, in some instances, transfers made without actual or constructive fraud, do not constitute transfers for value.<sup>243</sup> The Eleventh Circuit distinguished those decisions on the basis that they were not decided in the context of a Ponzi scheme and involved only claims of constructive fraud, not actual fraud, as is typically the case in a Ponzi scheme. Unlike the situation present in *Haines*, the cases relied upon by the trustee involved circumstances in which the debtors attempted to pay off their shareholders at the expense of creditors, but not where the investors were fraudulently induced to invest in the scheme.<sup>244</sup>

In concluding that the applicability of the section 548(c) good faith defense is not dependent upon the type of investments made in a Ponzi scheme context, the Eleventh Circuit explained that courts have not distinguished between equity investments and debt-based investments when evaluating fraudulent transfer claims in Ponzi scheme bankruptcies<sup>245</sup> and relied upon the Ninth

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<sup>240</sup>*Id.* (citing *In re M & L Business Mach. Co., Inc.*, 84 F.3d 1330, 1340–42, 29 Bankr. Ct. Dec. (CRR) 188, 36 Collier Bankr. Cas. 2d (MB) 996 (10th Cir. 1996); *In re United Energy Corp.*, 944 F.2d 589, 596, 22 Bankr. Ct. Dec. (CRR) 143, 25 Collier Bankr. Cas. 2d (MB) 740, Bankr. L. Rep. (CCH) P 74294 (9th Cir. 1991)).

<sup>241</sup>*Id.*

<sup>242</sup>*Id.*

<sup>243</sup>*Id.*

<sup>244</sup>*Id.* at 628.

<sup>245</sup>*Id.* Interestingly, the Eleventh Circuit did not address any of the recent precedent emanating from the *Bayou* or *Madoff* lines of cases.



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

Circuit's 2008 decision in *In re AFI Holding, Inc.*<sup>246</sup> The investors in *AFI Holding* purchased equity interests in the debtor, and received transfers during the operation of the scheme which were comprised both of purported returns on those equity investments and profits.<sup>247</sup> The trustee in *AFI Holding* sought to avoid those transfers, and the bankruptcy court authorized avoidance, finding that the transfers were not given "for value."<sup>248</sup> The district court reversed, holding that the transfers were made in satisfaction of the defrauded investors' restitution claims against the debtor.<sup>249</sup> The Ninth Circuit Court of Appeals affirmed, holding that the investors "were defrauded into their limited partnership role by the operator of the Ponzi scheme."<sup>250</sup> Therefore, the Ninth Circuit determined that the investors held restitution claims in the amounts of their investments and that the transfers at issue satisfied such claims.<sup>251</sup> Similarly, in *Haines*, the Eleventh Circuit upheld the bankruptcy court's denial of the trustee's motion for summary judgment, thus validating the investors' ability to assert the affirmative defense that the payments to them were received in good faith and for value up to the amount of each investor's principal investment.<sup>252</sup>

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<sup>246</sup>See *id.* at 628 (citing *In re AFI Holding, Inc.*, 525 F.3d 700, 708, 49 Bankr. Ct. Dec. (CRR) 243, Bankr. L. Rep. (CCH) P 81218 (9th Cir. 2008)).

<sup>247</sup>*In re AFI Holding*, 525 F.3d at 702.

<sup>248</sup>See *id.* at 704.

<sup>249</sup>*Id.*

<sup>250</sup>*Id.* at 708.

<sup>251</sup>*Id.*

<sup>252</sup>*Haines*, 661 F.3d at 629. Without mentioning *Haines*, the United States Bankruptcy Court for the Southern District of Florida recently examined whether to suspend the continued prosecution of a trustee's avoidance actions against a Ponzi scheme's "net losers" in the Chapter 11 case of *In re Rothstein Rosenfeldt Adler P.A.* See 464 B.R. 465 (Bankr. S.D. Fla. 2012). Rothstein Rosenfeldt Adler P.A. was a law firm through which Scott Rothstein operated a Ponzi scheme centered around the sale of interests in fictitious structured lawsuit settlements. After the scheme collapsed and the firm filed for bankruptcy protection, the trustee commenced avoidance actions against various parties, including "net winners" (those who collected more than they invested) and "net losers" (those who did not recover their principal investment). Certain of the investors moved to abate avoidance actions against certain net losers, purportedly so that the trustee could focus his attention and the estate's resources on litigation targets the movants deemed most culpable. The court denied the motion, citing a lack of detail about the proposed abatement's length and clear criteria for identifying and classifying net losers versus net winners. Significantly, the court observed that the motion was predicated on the assumption that the net losers had acted in good faith, an issue on which the defendants

## 2. *Merkin II—Leave To Appeal Denied*

Last year's edition of this article featured the bankruptcy court's decision in *Picard v. Merkin*<sup>253</sup> denying the defendants' (the "Merkin Defendants")<sup>254</sup> motions to dismiss the SIPA trustee's complaint seeking to avoid and recover allegedly fraudulent payments made to the Merkin Defendants in connection with their investments in BLMIS.<sup>255</sup> *Merkin I* held (a) that it was premature at the pleading stage to address the affirmative defenses provided by sections 548(c) and 546(e) of the Bankruptcy Code and (b) that the determination of whether the defendants' restitution claims provided reasonably equivalent value to defeat the trustee's claims alleging constructive fraud was inappropriate for a motion to dismiss, particularly where the trustee had adequately alleged that the defendants knew of Madoff's fraud and might not be entitled to the equitable claim of restitution.<sup>256</sup> *Merkin II* is the district court's consideration of a motion for leave to appeal the *Merkin I* decision.

In *Merkin II*, Judge Kimba Wood of the United States District Court for the Southern District of New York denied in its entirety the motion of the receiver for two of the Merkin Defendants, Ariel Fund Ltd. and Gabriel Capital L.P. (the "Funds"), seeking leave to appeal the bankruptcy court's denial of the motion to dismiss. In so doing, Judge Wood (a) ruled that the defendants failed to satisfy the standards for granting leave to appeal set forth in 28 U.S.C. § 1292(b) because there were no substantial

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plainly had the burden of proof under section 548(c) of the Bankruptcy Code. Absent factual discovery, the court found it was impossible to tell whether net losers were any less culpable than net winners. The court pointed out, since many avoidance action defendants in non-Ponzi scheme cases are owed more than they recovered from transfers that are the subject of avoidance actions, allowing the abatement of actions against self-proclaimed net losers in a Ponzi scheme could effectively elevate net losers above other types of defendants, such as trade creditors. *Id.* at 470.

<sup>253</sup>*In re Bernard L. Madoff Inv. Securities, LLC*, 440 B.R. 243, 53 Bankr. Ct. Dec. (CRR) 268, 64 Collier Bankr. Cas. 2d (MB) 957 (Bankr. S.D. N.Y. 2010), leave to appeal denied, 2011 WL 3897970 (S.D. N.Y. 2011).

<sup>254</sup>The Merkin Defendants were funds that were managed by J. Ezra Merkin ("Merkin") and direct and indirect investors BLMIS, the vehicle through which Madoff orchestrated a massive Ponzi scheme. Merkin was the sole general partner of Gabriel Capital; he was also the sole shareholder and sole director of Gabriel Capital Corporation, which in turn was the investment advisor to Ariel Fund Ltd. *In re Bernard L. Madoff Inv. Securities LLC*, 2011 WL 3897970, \*1 (S.D. N.Y. 2011).

<sup>255</sup>Gallagher, *supra* note 24 at Section III.A.2.

<sup>256</sup>See *Merkin I*, 440 B.R. at 273.

grounds for disputing the correctness of the bankruptcy court's decision in *Merkin I* and (b) held that an immediate review of the bankruptcy court's non-final order with respect to that decision was not required.<sup>257</sup>

With respect to the adequacy of the pleadings, the district court first observed that the bankruptcy court's decision denying the Merkin Defendants' motion to dismiss held that the SIPA trustee had sufficiently pleaded his federal and state law claims seeking avoidance and recovery of actual fraudulent transfers. In that regard, the bankruptcy court also held that the Merkin Defendants were not entitled to dismissal of claims asserting actual fraudulent transfer claims on the basis of the "good faith" affirmative defense provided in section 548(c) of the Bankruptcy Code.<sup>258</sup> Second, the bankruptcy court held that the SIPA trustee had sufficiently pleaded his federal and state law claims seeking avoidance of allegedly constructively fraudulent transfers and, in this regard, the Merkin Defendants were not entitled to dismissal of Bankruptcy Code-based constructive fraud claims pursuant to the safe harbor affirmative defense applicable to certain "settlement payments" contained in section 546(e) of the Bankruptcy Code.<sup>259</sup>

The district court reviewed in detail the issues raised by the Funds<sup>260</sup> and, in each instance, determined that the Funds were not entitled to an immediate appeal, as no substantial grounds

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<sup>257</sup>*In re Bernard L. Madoff Inv. Securities LLC*, 2011 WL 3897970, \*1 (S.D. N.Y. 2011). Section 1292(b) of title 28 of the United States Code provides that a district judge may allow for an appeal of a civil order that is otherwise not appealable if the judge is "of the opinion that such order involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the order may materially advance the ultimate termination of the litigation." 28 U.S.C. § 1292(b). The district court noted that, in addition to the three factors required by the statute, the movant must establish that "'exceptional circumstances . . . [exist that] . . . overcome the general aversion to piecemeal litigation' and justify departing from the basic policy of postponing appellate review until after entry of a final judgment." *In re Bernard L. Madoff Inv. Securities LLC*, 2011 WL 3897970, \*3 (S.D. N.Y. 2011) (quoting *In re Madoff*, 2010 WL 3260074, \*3 (S.D. N.Y. 2010)). For a discussion of the factors and applicable case law construing those factors see *In re Bernard L. Madoff Inv. Securities LLC*, 2011 WL 3897970, \*3–4 (S.D. N.Y. 2011).

<sup>258</sup>*Id.* at \*2.

<sup>259</sup>As noted in section II.A. note 52 of this article, 11 U.S.C. § 546(e) provides a "safe harbor" from recovery for certain recipients of, inter alia, constructive fraudulent transfers. The "safe harbor" does not apply to actually fraudulent transfers. See *Merkin I*, 440 B.R. at 266–67.

<sup>260</sup>In seeking leave to appeal the bankruptcy court's order, the Funds raised the following issues: (a) whether a complaint for actual fraud under section

existed for a difference of opinion as to the correctness of the standards relied upon by the bankruptcy court.

a. Transferee Intent Not Relevant to Allegations of Actual Fraudulent Transfer

The Funds contended that the complaint failed to allege facts sufficient to (a) connect the Funds to Madoff's fraudulent scheme to defraud and (b) support allegations of the Funds' fraudulent intent as part of the trustee's claims alleging that payments to the Funds were actually fraudulent. With respect to this contention, the district court analyzed applicable precedent decided under both the Bankruptcy Code and Section 276 of New York State's Debtor Creditor Law (the "NYDCL") and pointed out that neither section 548(a)(1)(A) of the Bankruptcy Code nor the analogous provision of the NYDCL<sup>261</sup> requires proof of the transferee's fraudulent intent in order to allege claims asserting actual fraudulent transfer.<sup>262</sup> Rather, both provide that only the transferor's fraudulent intent is relevant for pleading purposes.<sup>263</sup> In that regard, as noted by the district court, the requisite fraudulent intent on the part of BLMIS was satisfied by the trustee's allega-

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548(a)(1)(A) must allege facts sufficient to connect the defendant transferee to the alleged scheme to defraud creditors; (b) whether, for purposes of alleging actual fraudulent transfer under section 548(a)(1)(A), certain claims about Madoff's non-transparent manner of operating BMLIS and Merkin's failure to disclose the full extent of his relationship with Madoff were sufficient to the establish the transferee's fraudulent intent in accordance with the pleading requirements of Rule 9(b); (c) whether a complaint for actual fraudulent transfer under section 548(a) that fails to allege facts permitting an inference that defendants acted other than in good faith within the meaning of the defense provided by section 548(c) can withstand a motion to dismiss under Rule 12(b)(6); (d) whether a Ponzi scheme investor who received transfers totaling less than his principal investment must forfeit his remaining principal based upon a theory of constructive knowledge of the Ponzi scheme, absent a plea or proof of facts that who actual knowledge of, and participation by the investor in that scheme; and (e) whether BMLIS was a stockbroker or financial institution and were the payments it made pursuant to securities contracts so that the safe harbor of section 546(e) would preclude avoidance of any transfers on a constructive fraudulent transfer basis. *In re Bernard L. Madoff Inv. Securities LLC*, 2011 WL 3897970, \*3 (S.D. N.Y. 2011).

<sup>261</sup> See N.Y. Debtor and Creditor Law §§ 270 to 281 (McKinney 2001).

<sup>262</sup> *In re Bernard L. Madoff Inv. Securities LLC*, 2011 WL 3897970, \*7–8 (S.D. N.Y. 2011).

<sup>263</sup> *Id.* at \*4–5. The district observed that transferee intent is relevant under Section 278(1) of the NYDCL, which provides an affirmative defense transferees who received conveyances for "fair consideration" and "without knowledge of the fraud," and is an issue that should be considered on a full evidentiary record. *Id.* at \*6.

tions that the payments made by BLMIS to the Merkin Defendants were made in furtherance of Madoff's Ponzi scheme pursuant to the "Ponzi Scheme Presumption."<sup>264</sup>

b. Good Faith Affirmative Defense to Actual Fraudulent Transfer

*Merkin I* held that the Merkin Defendants were not entitled to dismissal of the actual fraudulent transfer claim pursuant to the affirmative defense set forth in section 548(c) of the Bankruptcy Code. That defense, as noted above, provides that transfers otherwise avoidable as fraudulent under section 548 of the Bankruptcy Code may not be avoided if made in exchange for value and in good faith, to the extent of the value provided to the debtor in exchange for such transfer.<sup>265</sup> In *Merkin II*, the district court quickly determined that, on this issue, no substantial ground for disputing the correctness of the standards applied by the bankruptcy court existed, noting that the bankruptcy court (a)

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<sup>264</sup>*Id.* at \*5. The "Ponzi Scheme Presumption" is a general rule that provides that where a Ponzi scheme exists, all of the transfers made in furtherance of the scheme are presumed to have been made with the actual intent to hinder, delay and defraud creditors. *Id.* at \*4; see also *In re Bayou Group, LLC*, 439 B.R. 284, 294 (S.D. N.Y. 2010); *In re Manhattan Inv. Fund Ltd.*, 397 B.R. 1, 8 (S.D. N.Y. 2007); *Drenis v. Haligiannis*, 452 F. Supp. 2d 418, 429 (S.D. N.Y. 2006). See generally *In re AFI Holding, Inc.*, 525 F.3d at 704 (noting that the existence of a Ponzi scheme is sufficient to establish actual intent to defraud under § 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); *Merkin I*, 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"); *In re 1031 Tax Group, LLC*, 439 B.R. 47, 72, 53 Bankr. Ct. Dec. (CRR) 180 (Bankr. S.D. N.Y. 2010), subsequent determination, 439 B.R. 84, 53 Bankr. Ct. Dec. (CRR) 247 (Bankr. S.D. N.Y. 2010) and opinion supplemented, 439 B.R. 78, 53 Bankr. Ct. Dec. (CRR) 246 (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 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 Fin., Inc.*, 326 B.R. at 850); *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").

<sup>265</sup>*In re Bernard L. Madoff Inv. Securities LLC*, 2011 WL 3897970, \*8 n. 10 (S.D. N.Y. 2011) (quoting 11 U.S.C. § 548(c)).

considered the possibility that the trustee could run the risk of unintentionally “pleading himself out of court” if he were to allege facts that establish the affirmative defense, and (b) found, to the contrary, that the trustee had pleaded numerous allegations calling into question the good faith of the Funds.<sup>266</sup> The district court further found that the trustee need not dispute the elements of the Funds’ good faith affirmative defense in order to survive a motion to dismiss.<sup>267</sup>

c. Constructive Fraud—Reasonably Equivalent Value or Fair Consideration

*Merkin II* also addressed the Funds’ argument that the bankruptcy court should have dismissed for failure to state a claim the trustee’s claims alleging constructive fraudulent transfer under section 548(a)(1)(B) of the Bankruptcy Code because BLMIS received reasonably equivalent value for the transfers made by the Funds. In this regard, in *Merkin I*, the Funds asserted that, as investors in Madoff’s fraudulent scheme, they were entitled to restitution for the principal amounts of their investments and that such restitution claims constituted antecedent debt, the satisfaction (or reduction) of which constituted “value” to the debtor-transferor.<sup>268</sup> The bankruptcy court held that the Merkin Defendants were not entitled to dismissal of these claims on the basis of the debtor’s receipt of “reasonably equivalent value” or “fair consideration” for purposes of section 548(a)(1)(B) of the Bankruptcy Code or of the NYDCL, respectively, because the trustee had alleged sufficient facts indicating

<sup>266</sup>*Id.* at \*8. The bankruptcy court did not address the standard for analyzing “good faith” for purposes of § 548(c) of the Bankruptcy Code.

<sup>267</sup>*Id.* (citing *In re Dreier LLP*, 452 B.R. 391, 426 (Bankr. S.D. N.Y. 2011)). The bankruptcy court presiding over the Ponzi scheme bankruptcy case of the law firm Dreier LLP held, inter alia, in analyzing the defendants/investors’ motions to dismiss that (i) a determination on the defendant’s good faith defense under section 548(c) to claims asserting actual fraud was premature (but seeming to adopt a subjective standard requiring either conscious turning away from facts or dereliction of a duty to inquire where such a duty exists), (ii) the debtor did not receive reasonably equivalent value in exchange for payments to the defendants that were in excess of principal, and (iii) the trustee could not recover payments of principal as constructively fraudulent transfers under New York Law, but that complaint stated claims for constructive fraudulent conveyance under New York law with respect to payments made in excess of principal amount of bogus promissory notes. *In re Dreier LLP*, 452 B.R. 391 (Bankr. S.D. N.Y. 2011); see also *In re Dreier LLP*, 462 B.R. 474 (Bankr. S.D. N.Y. 2011) (holding similarly).

<sup>268</sup>*In re Bernard L. Madoff Inv. Securities LLC*, 2011 WL 3897970, \*9 (S.D. N.Y. 2011).



that the Funds invested in BLMIS with culpable knowledge of the fraudulent scheme, which, if proven, would demonstrate that such transfers were not made in exchange for reasonably equivalent value under section 548(a)(1)(B) of the Bankruptcy Code or for “fair consideration” pursuant to sections 273 to 275 of the NYDCL.<sup>269</sup>

The district court in *Merkin II* likewise rejected these arguments. Noting that, under the Bankruptcy Code, whether a transfer was made in exchange for “reasonably equivalent value” is a fact-intensive inquiry and typically cannot be determined on the pleadings,<sup>270</sup> the district court distinguished *Merkin I* from decisions of other courts<sup>271</sup> holding that a debtor receives reasonably equivalent value in exchange for transfers to an investor that do not exceed the principal amount of the investment, so that only “false profits” received by the investor are subject to clawback.<sup>272</sup> The district court found these cases inapposite because they did not involve transferees, like the Funds, who allegedly invested in “bad faith,” and observed that the bankruptcy

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<sup>269</sup>*Id.* This holding is contrary to a holding on the same issue decided in *Picard v. Katz* published just a few weeks after the *Merkin II* decision was issued. See *Picard v. Katz*, 462 B.R. 447, 455–56, 55 Bankr. Ct. Dec. (CRR) 133, Bankr. L. Rep. (CCH) P 82077 (S.D. N.Y. 2011), motion to certify appeal denied, 466 B.R. 208, 55 Bankr. Ct. Dec. (CRR) 266 (S.D. N.Y. 2012). Also, this holding appears to add a lack of knowledge requirement that is not included in the plain language of the section 548(a)(1)(B).

<sup>270</sup>*In re Bernard L. Madoff Inv. Securities LLC*, 2011 WL 3897970, \*10 (S.D. N.Y. 2011).

<sup>271</sup>See, e.g., *In re Carrozzella & Richardson*, 286 B.R. 480, 487–88, 49 Collier Bankr. Cas. 2d (MB) 1182 (D. Conn. 2002) (“[W]hen facing fraudulent conveyance actions, investors may keep the principal amount of their investments, but they may not keep any profits from the scheme”) (citations omitted); *In re Churchill Mortg. Inv. Corp.*, 256 B.R. 664, 682 (Bankr. S.D. N.Y. 2000), decision aff’d, 264 B.R. 303, 46 Collier Bankr. Cas. 2d (MB) 851 (S.D. N.Y. 2001) (recognizing the “universally-accepted rule that investors may retain distributions from an entity engaged in a Ponzi scheme to the extent of their investments); see also *In re Independent Clearing House Co.*, 77 B.R. 843, 857 (D. Utah 1987) (holding that payments that did not exceed the investor’s principal investment were not avoidable under section 548(a)(2) because the debtors received “reasonably equivalent value”).

<sup>272</sup>*In re Bernard L. Madoff Inv. Securities LLC*, 2011 WL 3897970, \*10 (S.D. N.Y. 2011). As noted above, the Eleventh Circuit in *Haines* adopted the approach distinguished in *Merkin I* and *II*. The *Haines* decision was not cited by *Merkin II*. Also, as discussed *infra*, reasoning similar to that adopted in *Haines* was adopted by the district court in *Picard v. Katz*, 462 B.R. 447, 55 Bankr. Ct. Dec. (CRR) 133, Bankr. L. Rep. (CCH) P 82077 (S.D. N.Y. 2011), motion to certify appeal denied, 466 B.R. 208, 55 Bankr. Ct. Dec. (CRR) 266 (S.D. N.Y. 2012).

court found that the trustee had adequately pleaded facts allowing for the reasonable inference that the Funds knew or should have known of Madoff's fraud and helped to perpetrate it.<sup>273</sup>

In disposing of the Funds' similar arguments about the trustee's constructive fraudulent conveyance claims under the NYDCL, the district court noted that the facts of the lone decision cited by the Funds in support of their argument, *Sharp Int'l Corp. v. State Street Bank and Trust Co.*,<sup>274</sup> were distinguishable from the facts in *Merkin* because it was undisputed that the transferee's loan in *Sharp* "was made in good faith long before the purported fraudulent transfer."<sup>275</sup> Unlike in *Sharp*, the bankruptcy court in *Merkin I* found plausible the trustee's allegations that the Funds knew of Madoff's fraud at all relevant times. Thus, the district court found, "even if the Trustee were required to allege participation by the transferee in order to plead an absence of good faith, the bankruptcy court found that the trustee satisfied [that] burden."<sup>276</sup>

#### d. Constructive Fraud Claims—Section 546(e) Safe Harbor

In *Merkin I*, the bankruptcy court held that it was premature to determine the applicability of the safe harbor included in section 546(e) of the Bankruptcy Code to the constructive fraud claims against the Merkin Defendants when deciding a motion to dismiss.<sup>277</sup> In *Merkin II*, the Funds contended that they were entitled to dismissal of the constructive fraudulent transfer claims because the affirmative defense provided in section 546(e) of the Bankruptcy Code sheltered the transfers to the Funds from avoidance because BLMIS was either a "stockbroker" or a "financial institution" and that the payments to the Funds were

<sup>273</sup>*In re Bernard L. Madoff Inv. Securities LLC*, 2011 WL 3897970, \*10 (S.D. N.Y. 2011) (quoting *Merkin I*, 440 B.R. at 262).

<sup>274</sup>*Id.* at \*10 (citing *In re Sharp Intern. Corp.*, 403 F.3d 43, 44 Bankr. Ct. Dec. (CRR) 146 (2d Cir. 2005) ("*Sharp*"). In *Sharp*, the defendant bank made a loan to debtor, who then commenced a fraudulent scheme. Upon discovery of the debtor's possible fraud, defendant bank required immediate repayment of the loan. The trustee alleged that the loan's repayment was actually and constructively fraudulent. The Second Circuit affirmed the lower courts' dismissal of complaint, holding that the defendant bank acted in good faith and the trustee did not adequately plead actual fraud.

<sup>275</sup>*In re Bernard L. Madoff Inv. Securities LLC*, 2011 WL 3897970, \*10–11 (S.D. N.Y. 2011) (quoting *Sharp*, 403 F.3d at 55).

<sup>276</sup>*Id.* at \*11.

<sup>277</sup>*Merkin I*, 440 B.R. at 266.

made pursuant to “securities contracts.”<sup>278</sup> The bankruptcy court held that it was premature to dismiss the constructive fraud claims pursuant to section 546(e) because (a) it could not hold as matter of law that BLMIS was a stockbroker engaged in the business of effecting securities transactions<sup>279</sup> because BLMIS allegedly never purchased any securities and (b) it could not yet determine whether the account agreements governing the Funds’ relationship with BLMIS were “securities contracts” for purposes of section 546(e).<sup>280</sup> The district court found no substantial grounds for a difference of opinion in this regard because the Funds had cited no decisions (a) where a Ponzi scheme operator who executed no trades was deemed at the pleading stage to be a “stockbroker” for purposes of section 546(e) of the Bankruptcy Code and (b) in which an agreement was deemed to be a “securities contract” for purposes of the Bankruptcy Code, where that agreement (i) merely authorized one party to conduct future trades on behalf of another party, and (ii) did not by its terms effect the purchase, sale or loan of a security between the parties.<sup>281</sup>

### 3. *Picard v. Katz*—A Shift to Subjective Good Faith and Section 546(e) Shelters Claims of Constructive Fraud

Just weeks after Judge Wood issued the *Merkin II* decision,

<sup>278</sup>*Id.* As noted above in note 52, *supra*, section 546(e) prevents the trustee from avoiding transfers otherwise avoidable under sections 544, 545, 547, 548(a)(1)(B) and 548(b) if “a transfer made by or to (or for the benefit of) a . . . stockbroker . . . [or] financial institution . . . in connection with a securities contract.” 11 U.S.C. § 546(e). A “stockbroker” is a “person—(A) with respect to which there is a customer . . . and (B) that is engaged in the business of effecting transactions in securities . . .” 11 U.S.C. § 101(53A). A “securities contract” is defined as, *inter alia*, “a contract for the purchase, sale, or loan of a security.” 11 U.S.C. § 741(7)(A)(i) to (xi). The Funds contended that the alleged transfers from BLMIS were made by a stockbroker to a financial institution pursuant to a securities contract, and accordingly could not be avoided. *See Merkin I*, 440 B.R. at 266.

<sup>279</sup>This holding is at odds with a holding in *Picard v. Katz* on the same issue. *See Picard v. Katz*, 462 B.R. 447, 451–52, 55 Bankr. Ct. Dec. (CRR) 133, Bankr. L. Rep. (CCH) P 82077 (S.D. N.Y. 2011), motion to certify appeal denied, 466 B.R. 208, 55 Bankr. Ct. Dec. (CRR) 266 (S.D. N.Y. 2012) (“Because Madoff Securities was a registered stockbrokerage firm, all liabilities to customers are subject to the safe harbor set forth in section 546(e) of the Bankruptcy Code”).

<sup>280</sup>*In re Bernard L. Madoff Inv. Securities LLC*, 2011 WL 3897970, \*12 (S.D. N.Y. 2011). Section 546(e) of the Bankruptcy Code relies on the definition of “securities contract” set forth in § 741(7) of the Bankruptcy Code. Section 741 of the Bankruptcy Code provides definitions applicable to Stockbroker Liquidations conducted under the Bankruptcy Code.

<sup>281</sup>*In re Bernard L. Madoff Inv. Securities LLC*, 2011 WL 3897970, \*12 (S.D. N.Y. 2011).

and in contrast to that decision and the decision of the bankruptcy court in *Merkin I*, in the affiliated adversary proceeding of *Picard v. Katz*,<sup>282</sup> Judge Rakoff of the United States District Court for the Southern District of New York<sup>283</sup> granted the defendant-investors' motion to dismiss "all claims except those alleging actual fraud and equitable subordination and narrow[ed] the standard for recovery under the remaining claims."<sup>284</sup> Accordingly, the district court dismissed the counts of the SIPA trustee's lengthy complaint against the defendants<sup>285</sup> based on principles of (a) preference and (b) constructive fraud under the Bankruptcy Code and New York law, finding that under the plain language of section 546(e) of the Bankruptcy Code, the defendants were insulated from avoidance by the safe harbor provided by that section.<sup>286</sup> Although *Picard v. Katz* was settled on the eve of

<sup>282</sup>*Picard v. Katz*, 462 B.R. 447, 55 Bankr. Ct. Dec. (CRR) 133, Bankr. L. Rep. (CCH) P 82077 (S.D. N.Y. 2011), motion to certify appeal denied, 466 B.R. 208, 55 Bankr. Ct. Dec. (CRR) 266 (S.D. N.Y. 2012).

<sup>283</sup>This matter was before the United States District Court for the Southern District of New York, rather than the United States Bankruptcy Court for the Southern District of New York, where the underlying adversary proceeding was filed, because the reference of the adversary proceeding to the bankruptcy court was withdrawn. *Id.* at 450 n. 1.

<sup>284</sup>*Id.* at 450. As observed in note 259 of this article, the safe harbor does not cover actually fraudulent transfers arising under section 548(a)(1)(A) of the Bankruptcy Code.

<sup>285</sup>The defendants in *Picard v. Katz* include Fred Wilpon and Saul Katz, the owners of the New York Mets.

<sup>286</sup>*Picard v. Katz*, 462 B.R. at 450. The dismissal of these claims was premised upon the determination that the allegedly preferential or constructively fraudulent transfers were not avoidable as a matter of law pursuant to the plain language of section 546(e) of the Bankruptcy Code, which contains a safe harbor for certain categories of transfers involving settlement payments or transfers made in connection with securities contracts. As noted above, in the affiliated case of *Picard v. Merkin*, the bankruptcy court declined to make this finding at the pleading stage. See section II.A. of this article for the complete language of section 546(e). While a detailed discussion of the applicability of the section 546(e) safe harbor is beyond the scope of this article, it bears mention that in *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329, 55 Bankr. Ct. Dec. (CRR) 12, 65 Collier Bankr. Cas. 2d (MB) 1833 (2d Cir. 2011), the Second Circuit examined the issue of whether section 546(e) of the Bankruptcy Code, which shields "settlement payments" from avoidance actions in bankruptcy cases, extends to an issuer's payments to redeem its commercial paper prior to maturity. The Second Circuit in *Enron Creditors Recovery Corp.* held that the payments were protected because, among other reasons, the payments completed a securities transaction, and thus qualified as "settlement payments" as used in section 546(e) of the Bankruptcy Code. The *Enron* decision was also cited by the district court in *Picard v. Katz* for the same proposition in

trial,<sup>287</sup> as a result of the dismissal, the only claim for avoidance that would have proceeded to trial in that case was the trustee's claim for actual fraud under section 548(a)(1)(A) of the Bankruptcy Code.<sup>288</sup> In narrowing the standards for recovery, the district court held that, as to the trustee's claims of actual fraud under section 548(a)(1)(A) of the Bankruptcy Code, "the [t]rustee can recover defendant's net profits over the two years prior to bankruptcy simply by showing that the defendants failed to provide value for those transfers, but the [t]rustee can recover the defendant's return of principle during that same period only by showing an absence of good faith on the defendants' part based upon their willful blindness."<sup>289</sup> In issuing this decision, the district court made certain legal findings with respect to the defenses under sections 546(e) and 548(c) of the Bankruptcy Code that the bankruptcy court in *Merkin I* had deemed premature at pleading stage and that Judge Wood declined to review on an interlocutory basis.<sup>290</sup>

a. Section 546(e) Shelters Constructively Fraudulent and Preferential Transfers

The district court did not conduct an extensive analysis to

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the context of denying the trustee's motion seeking leave to appeal the district court's decision on the defendants' motion to dismiss. *See* 2012 WL 127397 (S.D.N.Y. Jan. 17, 2012).

<sup>287</sup>*See* Memorandum of Understanding, *Picard v. Katz*, No. 11-cv-03605 (S.D.N.Y. March 19, 2012). On the eve of trial and as this article was being completed, the parties in *Picard v. Katz* reached a settlement whereby the defendants will pay the trustee \$162 million, representing the fictitious profits withdrawn by the defendants over the 6-year period preceding the BLMIS liquidation proceeding. As part of the settlement, the defendants' customer claims will be allowed in full, and the recoveries from those claims will be funneled to the trustee to offset the amount of the settlement payment.

<sup>288</sup>Just weeks before the trial scheduled for March 19, 2012, the district court granted the trustee's motion for partial summary judgment, ordering that the trustee could recover profits from the defendants that had been received in the two years prior to the commencement of the liquidation in an amount not to exceed \$83,309,162 because the defendants failed to show that the profits had been received for value. *See Picard v. Katz*, 2012 WL 691551 (S.D. N.Y. 2012); *see also infra* notes 307 & 308 and related text.

<sup>289</sup>*Picard v. Katz*, 462 B.R. at 455–56. The court further noted that the burden of raising the good faith defense is initially on the defendants, but "the question of whether, once the defendants have made a prima facie showing of good faith, the burden shifts back to the Trustee to show lack of good faith, is an issue that need not be decided on this motion." *Id.* at 456 n.9.

<sup>290</sup>*Picard v. Katz* does not mention the existence of evidence indicating that the defendants in *Picard v. Katz* may have lacked good faith, as was the case in *Merkin I*.



conclude that the safe harbor for transfers involving settlement payments or transfers made in connection with securities contracts contained in section 546(e) of the Bankruptcy Code sheltered the allegedly preferential or constructively fraudulent transfers from BLMIS to the defendants. Rather, the district court looked to the plain language of section 546(e) and the related provisions of the Bankruptcy Code<sup>291</sup> and rejected the SIPA trustee's suggestion to disregard the language of the statute, because following it would supposedly result in an outcome contrary to the purpose of the statute.<sup>292</sup> In making this determination, the district court noted that, because BLMIS was a registered stock brokerage firm, the payments to its customers, such as the defendants, were subject to the safe harbor of section 546(e).<sup>293</sup> In addition to relying on the plain language of section 546(e) of the Bankruptcy Code, the district court quoted from a recent decision from the Second Circuit Court of Appeals, *In re Enron Creditors Recovery Corp.*, which observed that “[b]y restricting a bankruptcy trustee’s power to recover payments that are otherwise avoidable under the Bankruptcy Code, the safe harbor stands at the intersection of two important national legislative policies on a collision course—the policies of bankruptcy and securities law.”<sup>294</sup>

b. Section 548(c) Affirmative Defense Applies Absent Bad Faith and to the Extent of Value

After dismissing the trustee’s preference and constructive fraud claims, Judge Rakoff turned his attention to the trustee’s claims alleging actual fraudulent transfer. Stating that it was “patent” that all of the transfers made by BLMIS during the two-year period preceding the filing of liquidation proceedings were made with the actual intent to defraud present and future creditors because Madoff’s Ponzi scheme began more than two years before

<sup>291</sup>The district court noted that under section 741(7) of the Bankruptcy Code a “securities contract” is a “‘contract for the purchase, sale or loan of a security,’ which is the kind of contract [BLMIS] had with its customers.” *Picard v. Katz*, 462 B.R. at 452. The district court observed that § 741(8) of the Bankruptcy Code provides an extremely broad definition of “settlement payment” that would include all payments made by BLMIS to its customers. *Id.*

<sup>292</sup>*Id.* at 452. The district court also noted that a resort to the legislative history was also inappropriate in this case where the language of the statute was “plain and controlling on its face.” *Id.*

<sup>293</sup>*Id.* at 451.

<sup>294</sup>*Id.* (quoting *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329, 334, 55 Bankr. Ct. Dec. (CRR) 12, 65 Collier Bankr. Cas. 2d (MB) 1833 (2d Cir. 2011)).



the filings, the court explained that the issue before it was not whether the transfers to the defendants could be avoided, but rather to what extent.<sup>295</sup> Resolution of this issue, the district court explained, turned on its application of the good faith and for value defense set forth in section 548(c) of the Bankruptcy Code.<sup>296</sup> Thus, the district court ruled as a matter of law that to the extent that a customer, in good faith, gave value to BLMIS in exchange for the transfers it received, it would be protected by section 548(c) of the Bankruptcy Code.<sup>297</sup> However, the availability of that defense turned on whether the monies the trustee sought to recover were either the customers' principal or profits.<sup>298</sup>

i. Subjective Lack of Good Faith for Ponzi Scheme Investors

Concluding that it was "clear that the principal invested by any of Madoff's customers 'gave value to the debtor' "<sup>299</sup> for purposes of section 548(c), the district court held that principal invested by the defendants could not be subject to recovery absent a showing of bad faith on the part of the defendants.<sup>300</sup> To plead the defendants' bad faith, or lack of good faith, the trustee advanced two theories: first, that the customers received the funds "willfully blind" of the underlying fraudulent scheme (i.e. that they ignored certain "red flags" so as to secure short-term profit) or, in the alternative, that the defendants were on inquiry notice of the fraud but failed to diligently investigate BLMIS.<sup>301</sup> The distinction between the two approaches was, essentially, the difference between an objective (inquiry notice) versus a subjective

<sup>295</sup>*Id.* at 453.

<sup>296</sup>*Id.* For the full text of section 548(c), see *supra* note 38.

<sup>297</sup>*Picard v. Katz*, 462 B. R. at 453.

<sup>298</sup>*Id.* Like the defendants in *Merkin*, the defendants in *Picard v. Katz* relied on *In re Sharp Intern. Corp.*, 403 F.3d 43, 54, 44 Bankr. Ct. Dec. (CRR) 146 (2d Cir. 2005), in arguing that they should be entitled to keep amounts received from BLMIS in excess of principal. The district court rejected these arguments, noting that *Sharp* did not address actual fraudulent transfers. *Id.* at 453–54. The district court held that the defendants could only avail themselves of the affirmative defense of section 548(c) to shelter transfers relating to profits if they show not only that they took in good faith, but also for value, a showing that the district court believed the defendants would have difficulty making. *Picard v. Katz*, 462 B. R. at 454 at n. 6.

<sup>299</sup>*Picard v. Katz*, 462 B. R. at 453 (quoting 11 U.S.C. § 548(c)).

<sup>300</sup>*Id.*

<sup>301</sup>*Id.* at 454–55 (citing *In re Manhattan Inv. Fund Ltd.*, 397 B.R. 1, 22–23 (S.D. N.Y. 2007)).

tive (willful blindness) standard.<sup>302</sup> Although an objective standard is often used in other bankruptcy contexts, given the standards implemented in securities law fraud cases, the district court determined that the subjective standard was more appropriate within the context of a SIPA liquidation.<sup>303</sup> Thus, the district court held that the trustee could only recover the defendants' return of principal by showing an absence of good faith on defendants' part based on their "willful blindness."<sup>304</sup>

In contrast, with respect to the recovery of "profits" paid to customers by BLMIS, the district court concluded that profits were likely subject to recovery by the trustee because such profits were presumptively in excess of any value (principal) provided by the customer, irrespective of a customer's good (or bad) faith.<sup>305</sup> Thus, the only manner in which a defendant could preserve its

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<sup>302</sup>*Id.* at 455.

<sup>303</sup>*Id.* Judge Rakoff opined that the objective standard was not applicable in the securities law context because, inter alia, a securities investor "has no inherent duty to inquire about his stockbroker" and that "a lack of due diligence cannot be equated with a lack of good faith, at least so far as section 548(c) is concerned." *Id.* Judge Glenn of the United States Bankruptcy Court for the Southern District of New York employed a similar theory in his opinion in *In re Dreier LLP*, where he distinguished the district court's decision in *In re Manhattan Inv. Fund Ltd.*, 397 B.R. 1 (S.D. N.Y. 2007), and found that it was premature to rule on the merits of the defendant's good faith defense under section 548(c) of the Bankruptcy Code but indicated that the objective standard would not apply to the *Dreier* defendant because it, unlike the defendant in the *Manhattan Inv. Fund* case, did not owe a duty to anyone other than its own investors to investigate Marc Dreier's fraudulent scheme. *In re Dreier LLP*, 452 B.R. 391, 449 (Bankr. S.D. N.Y. 2011); see also *In re Dreier LLP*, 462 B.R. 474 (Bankr. S.D. N.Y. 2011) (holding similarly).

<sup>304</sup>*Picard v. Katz*, 462 B.R. at 455–56.

<sup>305</sup>*Id.* "In other words, while as to payments received by the defendants from [BLMIS] equal to a return on their principal, defendants can defeat the Trustee's claim of actual fraud by simply proving their good faith, as to the payments received by the defendants in excess of their principal, defendants can defeat the Trustee's claim of actual fraud only by showing that they not only were proceeding in good faith but also that they took for value." *Id.* The district court rejected the defendant's arguments that they should be entitled to resist avoidance of transfers relating to the profits reflected in the BLMIS monthly statements, as long as they acted in good faith, finding misplaced the defendants' reliance on the *Sharp* decision, which held that a conveyance which satisfies an antecedent debt made while a debtor is insolvent was neither fraudulent nor improper because the court in the *Sharp* case did not apply that holding to actually fraudulent transfers, but instead found that actual fraud had not been adequately alleged. *Id.* at 454 (citing *Sharp*, 403 F.3d at 54, 56). The district court found that a prima facie case for actual fraud was adequately pleaded and that *Sharp* in no way controlled whether defendants could avail themselves of the "good faith" defense of section 548(c). *Id.*

profits would be if it were able to show that it provided value in excess of its principal investment, which the court found was highly unlikely.<sup>306</sup>

Consistent with this decision, just weeks before the scheduled trial, Judge Rakoff granted the trustee's motion for partial summary judgment, ordering that the trustee could avoid and recover the transfers from the defendant/investors representing profits received during the two years prior to the commencement of the liquidation cases in an amount not to exceed \$83,309,162 because the defendants failed to show that their profits had been received for value. In so ordering, the district court "concluded that the 'value' the defendants gave to [BLMIS]—and therefore the amount that they received from [BLMIS] during the applicable two-year period that they can withhold from the Trustee under § 548(c) unless the Trustee shows bad faith—is equal to the amount of their investment."<sup>307</sup> The district court further observed that "the principal issue remaining for trial is whether the defendants acted in good faith when they invested in [BLMIS] in the two years prior to bankruptcy or whether, by contrast, they willfully blinded themselves to Madoff's Ponzi scheme."<sup>308</sup>

The *Picard v. Katz* decision is a landmark in the BLMIS liquidation because of its clear determinations on the applicability of the safe harbor provisions provided by sections 548(c) and 546(e) of the Bankruptcy Code within the context of stockbroker liquidations. *Picard v. Katz* demonstrates how those safe harbors can limit a trustee's avoidance powers when bankruptcy and securities laws are inconsistent.<sup>309</sup>

The Ponzi scheme decisions discussed in this article reveal a

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<sup>306</sup> *Id.*

<sup>307</sup> *Picard v. Katz*, 2012 WL 691551, \*1 (S.D. N.Y. 2012).

<sup>308</sup> *Id.* at \*2. Judge Rakoff expressed doubt that the trustee would be able to rebut the defendants' showing of good faith. *Id.* at \*1.

<sup>309</sup> While no longer particularly relevant in light of the settlement, early in 2012, Judge Rakoff denied the trustee's motion seeking certification of the three key rulings of the district court's September 2011 decision for interlocutory appeal. *Picard v. Katz*, 466 B.R. 208, 55 Bankr. Ct. Dec. (CRR) 266 (S.D. N.Y. 2012). Amazingly, in this decision Judge Rakoff states that he was unaware of Judge Woods's *Merkin II* decision when he issued his September opinion in *Picard v. Katz*. *Id.* at \*5. The main focus of decision was the SIPA trustee's efforts to introduce new arguments relating to § 546(e) in order to show a substantial ground for difference of opinion for purposes of satisfying the requirements of 28 U.S.C. § 1292(b). Interestingly, however, Judge Rakoff corrected his initial ruling dismissing Count 9 of the trustee's Amended Complaint which sought recovery from subsequent transferees pursuant to sections 544(b) and 550(a) of the Bankruptcy Code, and clarified that, to the extent a transfer

number of trends. *Haines, Picard v. Katz* and *In re Dreier LLP* confirm that investors may retain transfers representing a return of principal so long as such transfers were received in good faith. Among other things, *Merkin I* and *Merkin II* provide that the nature of the transferee may be relevant to whether a restitution claim may be asserted for purposes of demonstrating reasonably equivalent value in response to claims asserting constructive fraud. Further, while the *Merkin I* and *II* decisions suggest that the safe harbor of section 546(e) may not apply in Ponzi scheme cases regardless of whether the scheme is run through a fund or a broker-dealer, those decisions must now be read in light of the decisions in the related case of *Picard v. Katz*, which determined that the trustee's claims for constructive fraud were subject to dismissal because the safe harbor of section 546(e) applied to BLMIS as a stockbroker. Given the amounts at stake and these holdings within the Southern District of New York in the BLMIS liquidation, future decisions on these issues are likely. Should *Merkin I* ultimately withstand appeal, the powers of trustees in this regard will be strengthened significantly, making, in the case of BLMIS, the reallocation of assets to investors more likely. Investors who are deemed to have knowledge or who invest through non-innocent investors in a Ponzi scheme may be required to relinquish transfers representing principal investments, in addition to those for fictitious profits.

### **C. Defenses to Liability for Recovery for Avoided Transfers Pursuant to Section 550 of the Bankruptcy Code**

During 2011 the assertion of defenses and exceptions to liability for avoided fraudulent transfers under section 550 of the Bankruptcy Code<sup>310</sup> continued<sup>311</sup> to result in noteworthy decisions, both with respect to the determination of (a) who is either a

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to an initial transferee could have been avoided under section 548(a)(1)(A) of the Bankruptcy Code, the trustee could avoid to the same extent subsequent transfers of the same funds under section 550(a). The district court reinstated Count 9 "insofar as it [sought] to avoid subsequent transfers under § 550(a) wherever the Trustee could have avoided an initial transfer under 548(a)(1)(A)." *Id.* at \*6.

<sup>310</sup>The full text of section 550 of the Bankruptcy Code and its background is provided at section II.B. of this article.

<sup>311</sup>The 2011 edition of this article included a discussion of the Seventh Circuit's opinion in *Paloian v. LaSalle Bank, N.A.*, 619 F.3d 688, 53 Bankr. Ct. Dec. (CRR) 155, Bankr. L. Rep. (CCH) P 81840 (7th Cir. 2010), which held that the bankruptcy trustee could seek to recover avoidable payments from the debtor to LaSalle Bank, the trustee for a securitized pool of loans which included

“mere conduit” or an initial transferee who is otherwise excepted from liability under section 550(a)(1)<sup>312</sup> of the Bankruptcy Code and (b) the standards for analyzing the affirmative defense for subsequent transferees who took for value and in good faith under section 550(b)<sup>313</sup> of the Bankruptcy Code.<sup>314</sup>

*1. Developments in the Mere Conduit Defense to Initial Transferee Liability*

As a general rule, section 550(a) of the Bankruptcy Code provides for strict liability of initial transferees for transfers avoidable under section 548 of the Bankruptcy Code. However, a “mere conduit” of such transfers, who lacks control over the ultimate disposition of the funds or assets transferred, is typically not liable for recovery as an “initial transferee” or an entity “for whose benefit” an avoided transfer was made for recovery pursuant to section 550(a) of the Bankruptcy Code. Recently the

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a note from the debtor. See Gallagher, *supra* note 24. The basis for recovery in *Paloian* was the assertion that LaSalle Bank was an “initial transferee” of the payments for purposes of section 550(a)(1) of the Bankruptcy Code because LaSalle Bank was the legal owner of the trust. In *Paloian*, the funds at issue were paid into trust for the benefit of the investors and distributed by LaSalle Bank pursuant to the parties’ trust agreement. While LaSalle Bank argued that it was a “mere conduit” and compared itself to a bank holding money in a checking account for a customer, the Seventh Circuit’s concluded that a trustee to a securitized trust may be an “initial transferee” for purposes of section 550(a). This decision 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 Bank, as trustee, could make any required payments to a bankruptcy estate from the corpus of the trust, presumably without damage to itself, this does not resolve the conflict faced by trustees to securitized trusts who are contractually bound to transfer funds to the trust investors and have no beneficial interest in such funds. As discussed *infra*, the potential impact of *Paloian* 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.” Because the Seventh Circuit recognized that the trust’s investors are “the persons for whose benefit” the transfers are made for purposes of section 550(a), those investors are similarly unable to rely on the section 550(b) good-faith defense.

<sup>312</sup>Section 550(a) generally provides that avoided transfers may be recovered from initial transferees, recipients from initial transferees, and any entity for whose benefit the transfers were made. 11 U.S.C. § 550(a).

<sup>313</sup>Essentially, section 550(b) provides a defense to subsequent transferees of avoided transfers who took in good faith, for value and without knowledge of the voidability of the transfer avoided. 11 U.S.C. § 550(b).

<sup>314</sup>This topic was also a significant issue in *TOUSA I* and *TOUSA II* and is discussed at length in section III.A. of this article.

“mere conduit” theory for escaping liability for avoided transfers has generated some interesting, but not entirely consistent, decisions.

a. The Eleventh Circuit Adds a Good Faith Requirement

The Eleventh Circuit Court of Appeals in *Martinez v. Hutton (In re Harwell)*<sup>315</sup> recently examined the mere conduit defense to initial transferee liability for avoidable transfers. It determined that, in order to successfully invoke the mere conduit defense and avoid liability for recovery of fraudulent transfers pursuant to section 550(a)(1) of the Bankruptcy Code, the transferee must have acted in good faith. The Eleventh Circuit reversed (a) the trial court’s grant of summary judgment to the defendant based on the determination that he was not an initial transferee and (b) the district court’s affirmance of that decision,<sup>316</sup> and held that an attorney, allegedly the “mastermind” of his client’s fraudulent transfers through such attorney’s law firm trust account, could be an initial transferee upon a showing of the attorney’s lack of good faith.<sup>317</sup> Only the Fourth Circuit has held similarly.<sup>318</sup> The other circuits have declined to find a good faith requirement for mere conduits.<sup>319</sup>

In *Harwell*, the trustee appointed in the Chapter 7 case of Billy Jason Harwell (“BJH”) commenced a fraudulent transfer action in the bankruptcy court against BJH’s lawyer (“Hutton”), alleging that Hutton accepted proceeds of settlements on BJH’s behalf and then disbursed those funds to BJH, BJH’s family members and selected creditors, as directed by BJH.<sup>320</sup> Hutton accepted and transferred BJH’s settlement proceeds with knowledge of a judgment creditor’s substantial efforts to collect against BJH’s

<sup>315</sup>*In re Harwell*, 628 F.3d 1312, 54 Bankr. Ct. Dec. (CRR) 12, 64 Collier Bankr. Cas. 2d (MB) 1820, Bankr. L. Rep. (CCH) P 81909 (11th Cir. 2010) (“*Harwell*”).

<sup>316</sup>*Id.* at 1314, 1324.

<sup>317</sup>*Id.* at 1323, 1324.

<sup>318</sup>See *In re Harbour*, 845 F.2d 1254, 18 Collier Bankr. Cas. 2d (MB) 1214, Bankr. L. Rep. (CCH) P 72308, 92 A.L.R. Fed. 621 (4th Cir. 1988) (“*In re Harbour*”).

<sup>319</sup>See, e.g., *In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey*, 130 F.3d 52, 31 Bankr. Ct. Dec. (CRR) 978, 38 Collier Bankr. Cas. 2d (MB) 1851, Bankr. L. Rep. (CCH) P 77560 (2d Cir. 1997); *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) (“*Bonded Financial*”).

<sup>320</sup>*Harwell*, 628 F.3d at 1316.



assets. Those efforts included obtaining a turnover order and a writ of garnishment for the subject settlement funds, which was served upon Hutton.<sup>321</sup> A few weeks after the transfers from Hutton's trust account, BJH filed for protection under the Bankruptcy Code.

Prior to BJH's bankruptcy filing, a creditor obtained a judgment against BJH in the amount of \$1.4 million.<sup>322</sup> Around the same time, Hutton represented BJH in negotiating settlements of unrelated business disputes, settlements that resulted in payments to BJH totaling just over \$500,000. Pursuant to BJH's settlement agreements, the proceeds of the settlements were first deposited into Hutton's client trust account, then, in accordance with BJH's instructions, were disbursed by Hutton to BJH, certain of BJH's family members, and selected creditors of BJH. None of these funds were paid to the judgment creditor.<sup>323</sup>

In the litigation before the bankruptcy court, the Chapter 7 trustee sought to avoid the transfers of BJH's settlement proceeds to Hutton under section 548 of the Bankruptcy Code and recover from Hutton pursuant to section 550(a). Hutton moved for summary judgment,<sup>324</sup> arguing that he was not an initial transferee of the settlement proceeds because he did not have dominion or control over the funds because they were kept in and disbursed through his attorney trust account.<sup>325</sup> For purposes of the summary judgment ruling, the bankruptcy court expressly assumed that (1) "Hutton was the mastermind . . . that was driving all the pieces of what was a huge fraudulent conveyance of hundreds of thousands of dollars that would have been [otherwise] available for creditors," and (2) that Hutton "managed to coordinate things in a fashion that the settlement was concluded and the money funneled through Mr. Hutton's trust account to various preferred creditors and insiders in either preferential or fraudulent transfers."<sup>326</sup> Nonetheless, the bankruptcy court granted Hutton's motion for summary judgment, determining that Hut-

<sup>321</sup>*Id.* at 1315.

<sup>322</sup>*Id.* at 1314.

<sup>323</sup>*Id.*

<sup>324</sup>The appeal arose from Hutton's motion for summary judgment and, therefore, for purposes of its summary judgment ruling, the bankruptcy court viewed the facts and drew inferences in a light most favorable to the non-moving party, i.e. the Chapter 7 trustee in the *Harwell* bankruptcy case. *Id.* at 1316–17.

<sup>325</sup>*Id.* at 1316.

<sup>326</sup>*Id.*

ton was not an initial transferee of BJH's funds under section 550(a)(1) of the Bankruptcy Code because Hutton never had dominion and control over the money kept for BJH in the trust account. This ruling prevented the Chapter 7 trustee from recovering the fraudulently transferred funds from Hutton.<sup>327</sup>

The district court affirmed the bankruptcy court's decision,<sup>328</sup> concluding that the Eleventh Circuit's discussion in *In re Int'l Admin. Svcs., Inc.* of a good faith requirement for reliance on the mere conduit exception was dicta.<sup>329</sup> The district court held that Hutton had acted as a fiduciary and was obligated to disburse the funds from his trust account according to his client's instructions.<sup>330</sup> As a result, the district court found that Hutton exercised no control over the funds, as is required for initial transferee liability under section 550(a)(1) of the Bankruptcy Code.<sup>331</sup>

The main issue on appeal to the Eleventh Circuit was whether Hutton was an initial transferee for the purpose of section 550(a)(1) of the Bankruptcy Code. If Hutton were an initial transferee, the Chapter 7 trustee could recover from Hutton the \$500,000 placed in Hutton's trust account and distributed pursuant to BJH's instructions.<sup>332</sup> The Eleventh Circuit began its analysis by observing that the term "transferee" is not defined in the Bankruptcy Code.<sup>333</sup> It then conducted a thorough review of its earlier precedent addressing the mere conduit exception to liability of initial transferees and described the genesis and development of the control test it first articulated in *Nordberg v.*

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<sup>327</sup>*Id.*

<sup>328</sup>*Id.*; see *In re Harwell*, 414 B.R. 770, 785 (M.D. Fla. 2009).

<sup>329</sup>*In re Harwell*, 414 B.R. at 779; see *In re International Administrative Services, Inc.*, 408 F.3d 689, 705, 44 Bankr. Ct. Dec. (CRR) 178, Bankr. L. Rep. (CCH) P 80279 (11th Cir. 2005) ("In order for this exception to apply . . . we must determine whether [defendants] are merely conduits of the IAS funds, and whether IBT and SCSD are the resulting 'initial transferees.' As we read it, the conduit rule presumes that the facilitator of funds acts without bad faith, and is simply an innocent participant to the underlying fraud.").

<sup>330</sup>*In re Harwell*, 414 B.R. at 785.

<sup>331</sup>*Harwell*, 628 F.3d at 1316; *In re Harwell*, 414 B.R. at 785.

<sup>332</sup>*Harwell*, 628 F.3d at 1317. The Eleventh Court reviewed the bankruptcy court's factual determinations for clear error and its legal determinations *de novo*. *Id.* at 1316–17.

<sup>333</sup>*Id.* at 1317.

*Sanchez (In re Chase & Sanborn)*,<sup>334</sup> a fraudulent transfer action where the relevant issue was whether the funds transferred in and out of the debtor's bank account were property of the debtor that could be recovered from the bank.<sup>335</sup>

After a detailed review of the relevant Eleventh Circuit precedent addressing the control test and the term “mere conduit” for purposes of determining initial transferee liability within the Eleventh Circuit,<sup>336</sup> the circuit found that “a clear pattern

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<sup>334</sup>*Id.* at 1317–18 (citing *In re Chase & Sanborn Corp.*, 813 F.2d 1177, Bankr. L. Rep. (CCH) P 71753 (11th Cir. 1987) (“*Chase & Sanborn I*”).

<sup>335</sup>*Id.* at 1318. *Chase & Sanborn I* did not address initial transferee liability; rather, it dealt with whether funds that were fraudulently transferred were the debtor's property for purposes of section 548 of the Bankruptcy Code and determined that the debtor did not have sufficient control over the subject funds in its bank account for those funds to be considered property of the debtor. 813 F.2d at 1178–82.

<sup>336</sup>*See Harwell*, 628 F.3d at 1317–23. The remainder of this footnote describes that review. In *Chase & Sanborn I*, the circuit held that, in view of the entire circumstances of the transaction, where funds were placed by a third party into the debtor's account, but the debtor did not have control over the disposition of the funds, the funds were not the debtor's property and the transfer was not avoidable under section 548. 813 F.2d at 1182. In *In re Chase & Sanborn Corp.*, 848 F.2d 1196, Bankr. L. Rep. (CCH) P 72363 (11th Cir. 1988) (“*Chase & Sanborn II*”), the circuit held that while the defendant bank had received the funds from the debtor, technically making it an “initial transferee,” it would be inequitable to allow recovery where the defendant bank had no control over the funds. *Harwell*, 628 F.3d at 1319. The court in *Chase & Sanborn II* distinguished the deposit at issue from one where a debtor transfers money to a bank to repay a loan or other debt to the bank. *Harwell*, 628 F.3d at 1319 (quoting *Chase & Sanborn II* at 1200). The Eleventh Circuit in *Harwell* noted that in *In re International Administrative Services, Inc.*, 408 F.3d 689, 44 Bankr. Ct. Dec. (CRR) 178, Bankr. L. Rep. (CCH) P 80279 (11th Cir. 2005), it observed that a mere conduit cannot be considered an initial recipient for purposes of an avoidance action, and held that the defendants in the *Int'l Admin. Svcs., Inc.* case did not lack knowledge of the fraud as required by the mere conduit exception. 628 F.3d at 1320–21 (quoting 408 F.3d at 705: “As we read it, the conduit rule presumes that the facilitator of funds acts without bad faith, and is simply an innocent participant to the underlying fraud”). The *Int'l Admin. Svcs., Inc.* decision addressed the “good faith” issue and recognized that, in order to be a mere conduit, the recipient must have acted in good faith. 408 F.3d at 705. Finally, the Eleventh Circuit in *Harwell* reviewed its decision in *In re Pony Exp. Delivery Services, Inc.*, 440 F.3d 1296, 46 Bankr. Ct. Dec. (CRR) 24, Bankr. L. Rep. (CCH) P 80465 (11th Cir. 2006), in which it held that an insurance broker who held a debtor's deposit to cover insurance premiums did not exercise legal control over the funds and was not an initial transferee. 628 F.3d at 1321–22. The Eleventh Circuit in *Harwell* observed that in *Pony Express* it had noted that the mere conduit test takes on special significance when the transferee is “‘duty-bound to take only limited actions with respect to the funds

emerged.”<sup>337</sup> First, the circuit found that an initial transferee for purposes of section 550(a) of the Bankruptcy Code quite literally means the initial recipient of a debtor’s fraudulently transferred funds.<sup>338</sup> Second, the Eleventh Circuit observed that it had carved out an equitable exception to the *literal* statutory language of initial transferee through the mere conduit or control tests.<sup>339</sup> According to the Eleventh Circuit, the mere conduit or control defenses provide equitable exceptions to strict liability for an initial transferee’s fraudulent transfers because it would be inequitable to hold an initial recipient of a fraudulent transfer liable where such recipient “could not ascertain the transferor debtor’s solvency, or lacked any control over the funds, or lacked knowledge of the source of the funds.”<sup>340</sup> Third, the Eleventh Circuit observed that “[t]he conduit or control test is based on, and defined by, equity and requires good faith to escape ‘initial transferee’ liability. In effect, we have tempered literal application of section 550(a)(1), examining all of the facts and circumstances surrounding a transaction to prevent recovery from a transferee innocent of wrongdoing and deserving of protection.”<sup>341</sup> The Eleventh Circuit concluded that in order to rely upon the mere conduit or control theory for escaping liability, a defendant must make a showing of good faith,<sup>342</sup> stating:

[G]ood faith is a requirement under this Circuit’s mere conduit or control test. Accordingly, initial recipients of the debtor’s fraudulently transferred funds who seek to take advantage of the equitable exceptions to § 550(a)(1)’s statutory language must establish (1) that they did not have control over the assets, i.e. that they merely served as a conduit for the assets that were under the actual control

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received’. . . Often these fiduciaries or agents are not considered initial transferees because their legal control over the assets received is circumscribed by their legal duties to their clients.’ ” *Id.* at 1321 (quoting *Pony Express*, 440 F.3d at 1300–1).

<sup>337</sup>*Harwell*, 628 F.3d at 1322.

<sup>338</sup>*Id.* This is not a uniformly adopted view, as several courts have found that a mere conduit is not an initial transferee. *See* section III.C.3.b. of this article.

<sup>339</sup>*Harwell*, 628 F.3d at 1322 (emphasis added).

<sup>340</sup>*Id.* (citing *Chase & Sanborn II*, 848 F.2d at 1199–1202).

<sup>341</sup>*Id.* at 1322–23.

<sup>342</sup>*Id.* at 1323.

of the debtor-transferor and (2) that they acted in good faith as an innocent participant in the fraudulent transfer.<sup>343</sup>

The Eleventh Circuit dismissed Hutton's argument that the good faith principle discussed in *In re Int'l Admin. Svcs., Inc.* was only dicta, and held "explicitly . . . that good faith is a requirement under this Circuit's mere conduit or control test."<sup>344</sup> It concluded that Hutton was an initial transferee for purposes of section 550(a) of the Bankruptcy Code because he was the initial recipient of the debtor's funds from the settlements, an issue that Hutton did not dispute.<sup>345</sup> Upon resolving his business disputes, BJH had the settlement proceeds sent to Hutton. Even though Hutton quickly sent the funds to subsequent transferees, he unquestionably received them and deposited them into his trust account. As a result, "Hutton was the initial recipient of the funds, and thus the 'initial transferee' under the language of § 550(a)(1)."<sup>346</sup>

Because the bankruptcy court had only assumed for purposes of the summary judgment motion that Hutton was the mastermind of the debtor's scheme to fraudulently funnel the debtor-client's money into and out of Hutton's trust account, the Eleventh Circuit determined that triable issues of fact precluded summary judgment on Hutton's assertion of the "mere conduit" or "control defense."<sup>347</sup> Accordingly, the Eleventh Circuit remanded the case to the bankruptcy court for further findings on whether Hutton had acted in good or bad faith.<sup>348</sup>

On remand, the bankruptcy court found that Hutton had not acted in good faith and was not entitled to rely upon the mere conduit exception to initial transferee liability under section 550(a)(1) of the Bankruptcy Code.<sup>349</sup> The bankruptcy court in *Harwell II* observed that Hutton, as a Florida attorney, had no discretion in choosing the recipients of the money that BJH directed to Hutton's trust account since attorneys are bound to

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<sup>343</sup>*Id.* In reaching this conclusion, the Eleventh Circuit also relied upon the Fourth Circuit's decision in *In re Harbour*, 845 F.2d 1254, 1258, 18 Collier Bankr. Cas. 2d (MB) 1214, Bankr. L. Rep. (CCH) P 72308, 92 A.L.R. Fed. 621 (4th Cir. 1988).

<sup>344</sup>*Harwell*, 628 F.3d at 1323 n.10.

<sup>345</sup>*Id.* at 1323–24.

<sup>346</sup>*Id.* at 1324.

<sup>347</sup>*Id.*

<sup>348</sup>*Id.*

<sup>349</sup>*In re Harwell*, 2011 WL 4566443, \*4 (Bankr. M.D. Fla. 2011) ("*Harwell II*").

follow the instructions of their clients in distributing trust funds. Nonetheless, Hutton was not required to make his trust account available to BJH so that BJH could effect intentionally fraudulent transfers.<sup>350</sup> Since Hutton was aware that BJH was actively seeking to shelter the settlement proceeds from his judgment creditor's collection efforts, Hutton could have (and should have) refused to receive the settlement proceeds and insisted that the settlement agreements not make him the recipient of those funds.<sup>351</sup> Hutton also could have transferred the funds to BJH, rather than facilitating BJH's efforts to remove the funds from the reach of his judgment creditor.<sup>352</sup> The bankruptcy court made clear that this was not the case "of a bank, or for that matter an attorney, being unwittingly involved as the initial transferee of funds used as part of a scheme to defraud creditors under circumstances that would put the bank or attorney on notice of the intent to hinder or delay a creditor."<sup>353</sup> Because Hutton failed to show that he had acted in good faith and was an innocent participant in BJH's actions to hinder and delay his creditors, the bankruptcy court in *Harwell II* held that Hutton was liable as the initial transferee of BJH's funds.<sup>354</sup>

In *Harwell*, the Eleventh Circuit adopted a literal interpretation of the term "initial transferee" in section 550(a)(1) of the Bankruptcy Code. Unlike the jurisdictions which have determined that a mere conduit is not an initial transferee,<sup>355</sup> the Eleventh Circuit has carved out an equitable exception to the literal statu-

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<sup>350</sup>*Id.* at \*7.

<sup>351</sup>*Id.* at \*6.

<sup>352</sup>The evidence also showed that Hutton had sought legal counsel to advise him of his obligations with respect to the settlement proceeds, but that advice was limited to Hutton's obligations as a holder of garnished funds. The court then explored whether missing the fraudulent transfer legal issue was sufficient to support a finding that Hutton acted in good faith and was an innocent participant in the fraudulent transfer. *Id.* at \*7.

<sup>353</sup>*Id.*

<sup>354</sup>*Id.* at \*10.

<sup>355</sup>See, e.g., *In re Incomnet, Inc.*, 463 F.3d 1064, 47 Bankr. Ct. Dec. (CRR) 23, Bankr. L. Rep. (CCH) P 80717 (9th Cir. 2006) (applying the *Bonded Financial* dominion test and finding that the federal agency that collected funds as the administrator of an FCC trust had legal dominion over the funds and, thus, was an initial transferee); *In re Hurtado*, 342 F.3d 528, 41 Bankr. Ct. Dec. (CRR) 229, Bankr. L. Rep. (CCH) P 78904, 2003 FED App. 0312P (6th Cir. 2003) (applying the *Bonded Financial* dominion test and finding that a family member who held debtors' funds in her personal savings account and thus had legal control over said funds was the initial transferee); *In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey*, 130 F.3d 52, 31 Bankr. Ct. Dec.



tory language of section 550(a) for entities with no control over the fraudulently transferred funds and imposed a good faith requirement even though there is no mention of good faith in section 550(a)(1). The Eleventh Circuit relied on the plain language of the statute to find strict liability for initial recipients while adding a good faith requirement not expressly included in the statute.<sup>356</sup>

b. Trends in Mere Conduit Exception to Initial Transferee Liability

The 2011 edition of this article discussed the Seventh Circuit Court of Appeals' decision in *Paloian v. Lasalle Bank N.A.*,<sup>357</sup> where the Seventh Circuit determined that the trustee to a

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(CRR) 978, 38 Collier Bankr. Cas. 2d (MB) 1851, Bankr. L. Rep. (CCH) P 77560 (2d Cir. 1997) (applying *Bonded Financial* dominion test); *In re Southeast Hotel Properties Ltd. Partnership*, 99 F.3d 151, 29 Bankr. Ct. Dec. (CRR) 1202, 36 Collier Bankr. Cas. 2d (MB) 1649, Bankr. L. Rep. (CCH) P 77158 (4th Cir. 1996) (applying legal dominion test and holding that creditor, rather than agent of debtor, was the initial transferee of funds received from debtor's agent); *In re First Sec. Mortg. Co.*, 33 F.3d 42, 25 Bankr. Ct. Dec. (CRR) 1683, Bankr. L. Rep. (CCH) P 76046 (10th Cir. 1994) (applying the dominion test articulated in *Bonded Financial* and finding that bank was not the initial transferee of funds deposited in attorney trust account); *Matter of Coutee*, 984 F.2d 138, 28 Collier Bankr. Cas. 2d (MB) 762, Bankr. L. Rep. (CCH) P 75112 (5th Cir. 1993) (applying legal dominion or control test similar to test applied in *Bonded Financial* and holding that creditor bank was the initial transferee of funds used to repay loan, even though funds were first deposited into attorney trust account, because holders of attorney trust account did not have legal dominion or control over the funds held solely in a fiduciary capacity); *In re Anton Noll, Inc.*, 277 B.R. 875, 39 Bankr. Ct. Dec. (CRR) 353, 47 U.C.C. Rep. Serv. 2d 1393, 89 A.F.T.R.2d 2002-2672 (B.A.P. 1st Cir. 2002) (applying a combination of the *Bonded Financial* dominion and the *Chase & Sanborn* control tests to find that debtor's principal who converted cash from the debtor and used it to pay the IRS was the initial transferee, rather than the IRS, despite minimal time lapse between cash conversion and payment).

<sup>356</sup>Interestingly, Congress can and has specifically added good faith requirements to the Bankruptcy Code, including the good faith requirement contained in section 550(b), which limits a subsequent transferee's liability for avoided transfers. As noted in section II.A. of this article, the good faith exception to fraudulent transfer avoidance under 11 U.S.C. 548(c) applies only to transfers avoided under section 548 and, unlike section 550(b), requires that value be provided to the debtor. Section 550(b) prevents subsequent transferees from recovery for avoided transfers if they have taken for value, in good faith, and without knowledge of the voidability of the transfer. See section III.C.2. of this article for a discussion of good faith under section 550(b) of the Bankruptcy Code.

<sup>357</sup>*Paloian v. LaSalle Bank, N.A.*, 619 F.3d 688, 53 Bankr. Ct. Dec. (CRR) 155, Bankr. L. Rep. (CCH) P 81840 (7th Cir. 2010). See Gallagher, *supra* note 24.

securitized pool of loans, LaSalle Bank (“LaSalle”), could be liable as the initial transferee of transfers made by a debtor hospital through MMA Funding LLC (“MMA”), an entity that was intended to be bankruptcy remote.<sup>358</sup> In *Paloian*, a loan was made to the hospital that was subsequently sold and securitized.<sup>359</sup> The notes and interests related to the loan were transferred to a securitized trust, of which LaSalle was the trustee.<sup>360</sup> MMA made some payments on the loan to LaSalle on behalf of the hospital.<sup>361</sup>

In *Paloian* the Seventh Circuit rejected LaSalle’s arguments that it was a mere conduit and held that LaSalle, as trustee, was the legal owner of the securitization trust’s assets, and the initial transferee for purposes of an avoidance action to recover certain payments on the loan made to the trust, even though LaSalle lacked control over disbursement of the funds.<sup>362</sup> The Seventh Circuit determined that LaSalle’s contractual obligations to disburse the funds to the trust certificate holders of the trust did not conclusively establish LaSalle’s mere conduit status.<sup>363</sup> In reaching this conclusion the Seventh Circuit relied on the holding of *Bonded Financial*<sup>364</sup> for the proposition that LaSalle was

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<sup>358</sup>*Paloian*, 619 F.3d at 690. The Seventh Circuit remanded to the bankruptcy court the question of whether MMA was bankruptcy remote. *Id.* at 695–96. On remand, the bankruptcy court denied the trustee’s post-remand motion for summary judgment in the adversary proceeding seeking to avoid prepetition payments as fraudulent transfers. *See In re Doctors Hosp. of Hyde Park, Inc.*, 463 B.R. 93 (Bankr. N.D. Ill. 2011). The bankruptcy court considered the issues of (a) whether MMA was actually separate from the debtor so that it was a bankruptcy-remote entity and, if so, (b) whether the Hospital’s sale of accounts receivable to MMA was a true sale such that the Hospital’s Chapter 11 trustee could not recover payments made by MMA as fraudulent. It concluded that there were material issues of fact both as to the relevant entities operational separateness and whether the Hospital’s sale of receivables was a true sale. 463 B.R. at 113–14.

<sup>359</sup>*Paloian*, 619 F.3d at 690.

<sup>360</sup>*Id.*

<sup>361</sup>*Id.*

<sup>362</sup>*Id.* at 691.

<sup>363</sup>The Seventh Circuit in *Paloian* also discussed the practical advantage of allowing the bankruptcy trustee to recover from the trustee to the securitized pool who had direct access to the trust corpus, as opposed to seeking to recover from potentially thousands of investors in trust certificates. *Id.* at 692.

<sup>364</sup>*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) (holding that the recipient of a transfer (a bank) was not a transferee for purposes of § 550 of the Bankruptcy Code because it was an intermediary and had no dominion over the transferred funds).

the initial transferee because it was the legal owner of the trust's assets.<sup>365</sup>

Arguably, the Seventh Circuit's determination in *Paloian* that LaSalle was an initial transferee and not a mere conduit was unduly results-oriented and overlooked several practicalities, including the possibility that LaSalle was a subsequent transferee.<sup>366</sup> Similarly, the Eleventh Circuit in *Harwell* was not persuaded that Hutton was a mere conduit simply acting as a fiduciary who lacked discretion over the disbursement of the debtor's funds in his client trust account (he was not the legal owner of the funds), given the allegations that Hutton was complicit in the fraudulent transfer scheme that BJH conducted and carried out through Hutton's trust account. However, rather than adding a good faith requirement as an element of the mere conduit defense, the Eleventh Circuit might alternatively have found that Hutton had meaningful control over the funds because Hutton engineered the fraudulent transfer scheme, and therefore exercised some power over how the funds would be disbursed, even if he was obligated to transfer the settlement proceeds in accordance with BJH's instructions. Instead, the Eleventh Circuit determined that Hutton was an initial transferee because he was the first recipient of the fraudulent transfer and added a good faith requirement. This requirement imposes an additional evidentiary hurdle in the Eleventh Circuit for agents, banks, insurance brokers, and similar parties who (a) are duty-bound to take only limited actions with respect to funds owned by their clients and (b) seek to avoid liability under section 550(a) of the Bankruptcy Code as mere conduits.<sup>367</sup>

Although both the Eleventh and Seventh Circuits have both recently declined to find the mere conduit defense applicable in the *Harwell* and *Paloian* cases, respectively, the remaining circuits are not aligned, and a split on whether the mere conduit defense requires proof of good faith by the defendant transferee

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<sup>365</sup> *Paloian*, 619 F.3d at 691–92.

<sup>366</sup> The Seventh Circuit observed, however, that LaSalle Bank had not asserted it was a subsequent transferee entitled to rely upon section 550(b)'s affirmative defense. *Id.* at 692.

<sup>367</sup> See *Perlman v. Wells Fargo Bank, N.A.*, 830 F. Supp. 2d 1308 (S.D. Fla. 2011) (holding that bank must demonstrate good faith to invoke mere conduit defense in a Ponzi scheme fraudulent transfer action and relying on the *Harwell* decision); *In re Certified HR Services Co.*, 2009 WL 2913244 (Bankr. S.D. Fla. 2009) (holding that a finding of good faith is required in order to invoke the mere conduit defense and relying on *In re Chase & Sanborn Corp.*, 848 F.2d 1196, Bankr. L. Rep. (CCH) P 72363 (11th Cir. 1988)).

may be developing. For example, similar to the Eleventh Circuit's decision in *Harwell*, the United States Court of Appeals for the Fourth Circuit in *In re Harbour*<sup>368</sup> has held that the mere conduit defense is an equitable exception to initial transferee liability and one that inherently requires good faith on the part of the transferee.<sup>369</sup> However, the Seventh Circuit in *Bonded Financial*,<sup>370</sup> and the Second Circuit in *Finley, Kumble*<sup>371</sup> each declined to impose a good faith requirement for the "mere conduit" defense to liability under section 550(a)(1) of the Bankruptcy Code, and have found that mere conduits are not initial transferees.<sup>372</sup>

As discussed below, recent bankruptcy court decisions indicate that bankruptcy courts are applying a more straightforward analysis of the "mere conduit" test.

i. *In re Brooke Corp.*—Lead Bank for Note Participation Is a Mere Conduit

In a much-anticipated decision regarding a case of first impression, in *In re Brooke Corp.*, the United States Bankruptcy Court for the District of Kansas considered the issue of whether "[f]or purposes of § 550(a) . . . a lead bank holding a note of the debtor [is] an initial transferee or a conduit when it receives allegedly preferential payments from the debtor and, in accord with the participation agreement, immediately forwards the payments to

<sup>368</sup>*In re Harbour*, 845 F.2d 1254, 1258, 18 Collier Bankr. Cas. 2d (MB) 1214, Bankr. L. Rep. (CCH) P 72308, 92 A.L.R. Fed. 621 (4th Cir. 1988). The district court decision in *In re Harwell* discussed and distinguished *In re Harbour*. See 414 B.R. at 775–76.

<sup>369</sup>See also 5 Collier on Bankruptcy at ¶ 540.550.02[4][b] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2012).

<sup>370</sup>*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) (bank who took check payable to bank's order with note directing bank to deposit check into account of affiliate of transferor was an intermediary and not an initial transferee, but was a subsequent transferee who took it in good faith and for value and without knowledge of the voidability of the transfer).

<sup>371</sup>*In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey*, 130 F.3d 52, 31 Bankr. Ct. Dec. (CRR) 978, 38 Collier Bankr. Cas. 2d (MB) 1851, Bankr. L. Rep. (CCH) P 77560 (2d Cir. 1997) (despite insurance broker's participation in law firm's insurance selection, following that decision, the insurance broker was a mere conduit for premiums transferred from debtor to insurer).

<sup>372</sup>*Id.* at 57–58; *Bonded Financial*, 838 F.2d at 894–95 (rejecting approach that the court may use its equitable powers under § 550(a) to expand "initial transferees" to include "anyone who touches the money" and finding that an initial transferee must have dominion over the subject of the transfer and the right to put the money to one's own purposes).

the participants.”<sup>373</sup> The bankruptcy court granted the lead bank’s motion for partial summary judgment and held that the lead bank to the loan participation was a mere conduit for purposes of section 550(a)(i) and not the initial transferee with respect to funds it transmitted to participants who had purchased their interests in the debtor’s note. As a result, the debtor could not recover such payments from the lead bank if such payments were found to be preferential.<sup>374</sup>

In holding that the lead bank for the loan participation was a mere conduit, the bankruptcy court in *Brooke* employed the Seventh Circuit’s control test under *Bonded Financial* when observing that the lead bank had an unequivocal legal duty pursuant to the participation agreements to distribute funds to the other participants within 10 days of receipt. The lead bank “could not, without breach of the Agreements and its legal obligations to [the other participants], use the funds for its own purposes.”<sup>375</sup> The bankruptcy court in *Brooke* further noted that finding that the lead bank “was a conduit, not an initial transferee, facilitates the Trustee’s recovery of money from the [other participants], the real recipients of allegedly preferential transfers.”<sup>376</sup> The bankruptcy court in *Brooke* specifically distinguished the Seventh Circuit’s holding in *Paloian* because, in *Paloian*, LaSalle Bank, as trustee to the securitized investment pool, was the legal owner of the trust’s assets and could draw money from the trust corpus for any liability for avoided transfers. In *Brooke*, the lead bank of the loan participation was not the trustee and the loan participants, not the lead bank, were the legal owners of their interests in the note issued by the debtor.<sup>377</sup>

ii. *In re Bower* Adopts the “Control Test”

In an decision not easily reconcilable with the result in *Paloian*, the United States Bankruptcy Court for the District of Massachusetts in *In re Bower*<sup>378</sup> recently relied upon *Bonded Financial*’s “dominion and control test” to hold that a defendant/

<sup>373</sup>*In re Brooke Corp.*, 458 B.R. 579, 585, 55 Bankr. Ct. Dec. (CRR) 154 (Bankr. D. Kan. 2011) (“*Brooke*”).

<sup>374</sup>*Id.* at 591.

<sup>375</sup>*Id.* at 587 (citing *Bonded Financial*, 838 F.2d at 893).

<sup>376</sup>*Id.*

<sup>377</sup>*Id.* at 590–91.

<sup>378</sup>*In re Bower*, 462 B.R. 347, Bankr. L. Rep. (CCH) P 82143 (Bankr. D. Mass. 2012).

nominee<sup>379</sup> of a mortgage noteholder who held legal title to the mortgage at issue was a “mere conduit,” and not an initial transferee, for purposes of recovery under section 550(a) of the Bankruptcy Code.<sup>380</sup> The bankruptcy court found that, although the nominee held legal title and had the right to foreclose under Massachusetts law, pursuant to the terms of the mortgage instrument and the rules governing the nominee’s relationship with the holder of the mortgage note, the nominee was an agent who lacked authority to act without direction from the noteholder or servicer. As such, the nominee was a mere conduit and not liable for recovery under section 550(a).<sup>381</sup>

iii. *In re Lambertson Truex, LLC* Adopts the “Control Test”

In a recent decision from the Bankruptcy Court for the District of Delaware, *In re Lambertson Truex, LLC*,<sup>382</sup> the court followed the “control” test advanced by the Seventh Circuit in *Bonded Financial*. In *Lambertson Truex*, the bankruptcy trustee sought to recover an unauthorized postpetition payment to a law firm engaged by the debtor to register the debtor’s trademark.<sup>383</sup> The defendant firm outsourced the vast majority of the work to a second firm, and argued that the portion of the transfer attributable to the second firm was protected by the mere conduit defense.<sup>384</sup> The court held that, because the defendant firm had already paid the second firm’s invoice prior to receipt of the transfer from the debtor, the defendant firm had control over the funds and was not obligated to funnel the funds directly to the second law firm. Accordingly, the defendant was not deemed to be a “mere conduit.”<sup>385</sup>

<sup>379</sup>The nominee was Mortgage Electronic Registration Systems, Inc., often referred to as “MERS.” *Id.* at 348. As nominee, MERS held legal title to the mortgage, which allowed the underlying note to be freely transferred. *Id.* at 353.

<sup>380</sup>The mortgage was previously ordered avoided by the bankruptcy court pursuant to section 544(a)(3) because the debtor’s name was omitted from the mortgage acknowledgement—a material defect. *Id.* at 350.

<sup>381</sup>*Id.* at 353–54.

<sup>382</sup>*In re Lambertson Truex, LLC*, 458 B.R. 155, 55 Bankr. Ct. Dec. (CRR) 148 (Bankr. D. Del. 2011).

<sup>383</sup>*Id.* at 157.

<sup>384</sup>*Id.* at 159.

<sup>385</sup>*Id.* at 159–160.



2. *In re Nieves*: “Good Faith” and “Without Knowledge” for the Section 550(b) Safe Harbor

The Eleventh Circuit Court of Appeals is not the only court of appeals to recently examine the standards for analyzing the “good faith” requirement for avoiding liability under section 550 of the Bankruptcy Code. In *Nieves*,<sup>386</sup> the Fourth Circuit Court of Appeals also examined the requirements of good faith, albeit with respect to a defendant relying on the affirmative defense for subsequent transferees provided in section 550(b) of the Bankruptcy Code.

As discussed above, section 550(b) of the Bankruptcy Code contains a safe harbor that protects recipients of alleged fraudulent transfers who are not initial transferees or the entities for whose benefit such transfers were made from liability for recovery from an avoidance action brought under, among other sections, sections 544 and 548 of the Bankruptcy Code. Specifically, section 550(b)(1) provides that a subsequent transferee will be protected from liability if the subsequent transferee took (i) for value, (ii) in good faith, and (iii) without knowledge of the voidability of the transfer.<sup>387</sup> All three prongs of section 550(b)(1) must be satisfied in order to rely on the safe harbor.<sup>388</sup> However, since the Bankruptcy Code does not define good faith, courts have grappled over the definition of good faith, as is apparent from discussions throughout this article.<sup>389</sup> The Fourth Circuit Court of Appeals, in a case of first impression in that circuit, examined this issue in *Nieves* and concluded that (a) for purposes of section 550(b) of the Bankruptcy Code good faith is determined by an objective standard and (b) a subsequent transferee who

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<sup>386</sup>*In re Nieves*, 648 F.3d 232, 242, 65 Collier Bankr. Cas. 2d (MB) 1442, Bankr. L. Rep. (CCH) P 82024 (4th Cir. 2011) (“*Nieves*”).

<sup>387</sup>*See id.*; 11 U.S.C. § 550(b)(1).

<sup>388</sup>11 U.S.C. § 550(b)(1); *Nieves*, 648 F.3d at 242.

<sup>389</sup>In fact, the definition of “good faith” is widely variable. A number of courts have held that good faith defies precise definition and, as a result, must be determined on a case-by-case basis. *See, e.g., In re Roco Corp.*, 701 F.2d 978, 984, 10 Bankr. Ct. Dec. (CRR) 275, 8 Collier Bankr. Cas. 2d (MB) 457, Bankr. L. Rep. (CCH) P 69088 (1st Cir. 1983) (good faith, with respect to § 548(c), is not susceptible to precise definition); *In re Grove-Merritt*, 406 B.R. 778, 810 (Bankr. S.D. Ohio 2009) (good faith should be determined on case-by-case basis); *In re World Vision Entertainment, Inc.*, 275 B.R. 641, 659 (Bankr. M.D. Fla. 2002) (good faith defies precise definition); *In re Kanterman*, 97 B.R. 768, 779 (Bankr. S.D. N.Y. 1989), *aff’d*, 108 B.R. 432 (S.D. N.Y. 1989) (good faith should be defined on a case-by-case basis).

“willfully turned a blind eye to a suspicious transaction” did not satisfy the good faith prong of section 550(b).<sup>390</sup>

The Fourth Circuit in *Nieves* also examined the standard applicable to the “without knowledge” requirement of section 550(b), as well as whether mediate or immediate (i.e. subsequent) transferees are subject to a different standard than initial transferees under the good faith prong of section 550(b).<sup>391</sup> In deciding these issues, the Fourth Circuit affirmed the rulings of both lower courts on the issue of good faith.<sup>392</sup> It held that for purposes of section 550(b), “without knowledge” means that a defendant does not have actual knowledge of facts that would lead a reasonable person to believe that a transfer was voidable, that good faith should be determined under an objective standard,<sup>393</sup> and that the good faith standard applicable to subsequent transferees is the same as that required for initial transferees.

In *Nieves*, Walter Nieves (“Nieves”), shortly before filing for protection under Chapter 13 of the Bankruptcy Code, transferred

<sup>390</sup>*Nieves*, 648 F.3d at 242.

<sup>391</sup>In this instance, Capital City Mortgage Corporation was a mediate transferee of the Initial Transferee (as defined below). *See In re Nieves*, 2007 WL 2915004, \*4 (Bankr. D. Md. 2007), order aff’d, 2008 WL 3989144 (D. Md. 2008), aff’d, 648 F.3d 232, 65 Collier Bankr. Cas. 2d (MB) 1442, Bankr. L. Rep. (CCH) P 82024 (4th Cir. 2011).

<sup>392</sup>*Nieves*, 648 F.3d at 241–42; *see also In re Nieves*, 2008 WL 3989144 (D. Md. 2008), aff’d, 648 F.3d 232, 65 Collier Bankr. Cas. 2d (MB) 1442, Bankr. L. Rep. (CCH) P 82024 (4th Cir. 2011).

<sup>393</sup>The Fourth Circuit noted that its decision was consistent with a number of similar decisions from courts in other circuits holding that good faith is determined by an objective standard. *Nieves*, 648 F.3d at 238–39, 241; *see, e.g., In re Sherman*, 67 F.3d 1348, 1355, 27 Bankr. Ct. Dec. (CRR) 1237, 34 Collier Bankr. Cas. 2d (MB) 655, Bankr. L. Rep. (CCH) P 76671 (8th Cir. 1995); *In re Agricultural Research and Technology Group, Inc.*, 916 F.2d 528, 535–36, 23 Collier Bankr. Cas. 2d (MB) 1517, Bankr. L. Rep. (CCH) P 73652 (9th Cir. 1990); *Bonded Financial*, 838 F.2d at 897–98 (applying an objective standard of “good faith” to a subsequent transferee for purposes of § 550(b)); *In re Laines*, 352 B.R. 397, 406 (Bankr. E.D. Va. 2005) (citing *Brown*, 67 F.3d at 1355) (stating similarly); *see also, In re Enron Corp.*, 340 B.R. 180, 208, 46 Bankr. Ct. Dec. (CRR) 71 (Bankr. S.D. N.Y. 2006) (citing *In re M & L Business Mach. Co., Inc.*, 84 F.3d 1330, 1338, 29 Bankr. Ct. Dec. (CRR) 188, 36 Collier Bankr. Cas. 2d (MB) 996 (10th Cir. 1996)) (utilizing an objective standard in defining “good faith”). *But see In re Teleservices Group, Inc.*, 444 B.R. 767, 815 (Bankr. W.D. Mich. 2011) (applying a subjective approach that considers the actual knowledge of the transferee at the time of the transfer). The Fourth Circuit, however, is one of the few circuits that has imposed a “good faith” requirement for initial transferee exemption from liability. *See* section III.C.1. of this article.

a parcel of land for no consideration.<sup>394</sup> Approximately eight months later, the initial transferee transferred the land to 1st Financial Mortgage Services LLC (“1st Financial”) for alleged consideration of \$18,000.<sup>395</sup> Sixteen days before the land was transferred to 1st Financial, Michael Nastasi (“Nastasi”), a friend of Nieves and the owner of 1st Financial, approached Capital City Mortgage Corporation (“CCM”) and applied for a loan on behalf of 1st Financial, with such loan to be secured by the land.<sup>396</sup> In deciding whether to lend to 1st Financial, CCM did not utilize standard industry processes for approval of the loan.<sup>397</sup> Specifically CCM did not attempt to: (i) verify 1st Financial’s corporate good standing certification,<sup>398</sup> (ii) verify whether Nastasi was an authorized signatory of 1st Financial; (iii) obtain any financial information regarding 1st Financial; (iv) verify the validity of 1st Financial’s deed to the land; or (v) perform a title search with respect to the land.<sup>399</sup> Nonetheless, CCM made a loan in the amount of \$155,000 to 1st Financial, which loan was secured by the land.<sup>400</sup> After issuance of the loan, the Chapter 13 case was dismissed and Nieves subsequently filed a Chapter 7 petition.<sup>401</sup> 1st Financial never made any payments on the loan from CCM and CCM later asserted a right to the proceeds of any sale of the land in the Chapter 7 case.<sup>402</sup>

The Chapter 7 trustee (the “Trustee”) overseeing the case filed adversary proceedings against the initial transferee, 1st Financial and CCM<sup>403</sup> seeking to avoid and recover all of the transfers re-

<sup>394</sup>*Nieves*, 648 F.3d at 235–36.

<sup>395</sup>*Id.*

<sup>396</sup>*Id.*

<sup>397</sup>*Id.* at 241–42.

<sup>398</sup>In fact, at the time of the initial meeting between Nastasi and CCM, as well as when the land was transferred, 1st Financial was not a valid business entity. *Id.* at 236.

<sup>399</sup>*Id.* at 234–36.

<sup>400</sup>*Id.* at 234.

<sup>401</sup>*Id.* at 236.

<sup>402</sup>*Id.* at 234–36. The land was sold for \$475,000 in the Debtor’s Chapter 7 case; see also *In re Nieves*, 2007 WL 2915004, \*3–4 (Bankr. D. Md. 2007), order aff’d, 2008 WL 3989144 (D. Md. 2008), aff’d, 648 F.3d 232, 65 Collier Bankr. Cas. 2d (MB) 1442, Bankr. L. Rep. (CCH) P 82024 (4th Cir. 2011).

<sup>403</sup>*Nieves*, 648 F.3d at 235–36.

lating to the land pursuant to sections 544<sup>404</sup> and 550 of the Bankruptcy Code.<sup>405</sup> Although the transfers to the initial transferee and 1st Financial were avoided consensually, CCM challenged the avoidability of the transfer of the land from 1st Financial to CCM. Following a trial, the bankruptcy court ruled in favor of the Trustee, avoided the transfer to CCM and ordered that the Trustee could recover from the proceeds of the sale of the land, finding that CCM was not entitled to protection under section 550(b) because it did not take in good faith and without knowledge of the voidability of the transfer.<sup>406</sup> The district court affirmed.<sup>407</sup> On appeal to the Fourth Circuit, CCM argued that both lower courts had applied an incorrect standards for good faith and knowledge when analyzing the affirmative defense provided by section 550(b) of the Bankruptcy Code.<sup>408</sup>

a. Determining a Transferee's Knowledge for the Purpose of Section 550

In deciding whether the lower courts had applied the correct standards for analyzing eligibility to rely on the affirmative defense provided by section 550(b) of the Bankruptcy Code, the Fourth Circuit first acknowledged that the Bankruptcy Code provides no definition as to “what it means to take ‘in good faith’ or ‘without knowledge of the voidability of the transfer avoided.’”<sup>409</sup> The Fourth Circuit noted that it had only once before examined section 550(b) of the Bankruptcy Code, in *Smith v. Mixon*, when it addressed the issue of what constitutes knowledge for the purposes of section 550(b)(1) of the Bankruptcy

<sup>404</sup>Section 544 allows a trustee to “avoid any transfer of an interest of the debtor in property . . . that is voidable under applicable law by a creditor holding an unsecured claim.” 11 U.S.C. § 544(b).

<sup>405</sup>*Nieves*, 648 F.3d at 235–36.

<sup>406</sup>*Id.* at 236; *see also In re Nieves*, 2007 WL 2915004, \*7–8 (Bankr. D. Md. 2007), order aff’d, 2008 WL 3989144 (D. Md. 2008), aff’d, 648 F.3d 232, 65 Collier Bankr. Cas. 2d (MB) 1442, Bankr. L. Rep. (CCH) P 82024 (4th Cir. 2011).

<sup>407</sup>*Nieves*, 648 F.3d at 236; *see also In re Nieves*, 2008 WL 3989144, \*3–4 (D. Md. 2008), aff’d, 648 F.3d 232, 65 Collier Bankr. Cas. 2d (MB) 1442, Bankr. L. Rep. (CCH) P 82024 (4th Cir. 2011).

<sup>408</sup>*Nieves*, 648 F.3d at 237–39.

<sup>409</sup>*Id.* at 237.

Code.<sup>410</sup> In *Smith v. Mixon*, the Fourth Circuit held that knowledge for purposes of section 550(b)(1) of the Bankruptcy Code did not mean constructive notice, but rather meant actual notice.<sup>411</sup>

The bankruptcy court's application of *Mixon*'s actual notice standard was the primary basis for CCM's appeal. Specifically, CCM argued that the bankruptcy court erred in holding that *Mixon* did not limit knowledge to facts of which a defendant was cognitive, arguing that its application was too broad.<sup>412</sup> The Fourth Circuit disagreed with the bankruptcy court's conclusion that CCM took the land with knowledge of the voidability of the transfer, and, in fact, the Fourth Circuit recognized that CCM did not have actual knowledge of facts that would lead a reasonable person to believe that the transfer was voidable. The Fourth Circuit, however, agreed with the bankruptcy court's reading of *Mixon*, to the extent that, in determining CCM's knowledge, it held CCM to a constructive or inquiry notice standard, regardless of what CCM actually knew about the transfer.<sup>413</sup>

In addition, the Fourth Circuit clarified its holding in *Mixon*, noting that it went beyond stating merely that knowledge, for the purposes of section 550(b)(1) of the Bankruptcy Code, is limited to actual notice.<sup>414</sup> The Fourth Circuit explained that *Mixon*'s standard means that when no available facts suggest the existence of a potentially fraudulent transfer, there is no duty to investigate or be a watchdog for a creditor's benefit.<sup>415</sup> The Fourth Circuit further explained that where a transferee knew of facts that would lead a reasonable person to believe that the transferred property was recoverable, such a transferee would be held

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<sup>410</sup>*Id.* (citing *Smith v. Mixon*, 788 F.2d 229, 232, 14 Bankr. Ct. Dec. (CRR) 688, 14 Collier Bankr. Cas. 2d (MB) 704, Bankr. L. Rep. (CCH) P 71080 (4th Cir. 1986)).

<sup>411</sup>*Mixon* involved a situation where the transferees of a parcel of property, which was encumbered by a fraudulent deed of trust, sought protection from a bankruptcy trustee's avoidance action with respect to the transfer of the property. *Mixon*, 788 F.2d at 230–31. While the district court allowed the bankruptcy trustee to avoid the transaction, the Fourth Circuit reversed the district court and held that the transferee had taken the property in “good faith” and for value and, thus, the transfer was not subject to avoidance. *Id.* at 231–32.

<sup>412</sup>*Nieves*, 648 F.3d at 237.

<sup>413</sup>*Id.* at 241.

<sup>414</sup>*Id.* at 237–38 (citing *Mixon*, 788 F.2d at 232).

<sup>415</sup>*Id.* at 238 (citing *In re Bressman*, 327 F.3d 229, 237, 41 Bankr. Ct. Dec. (CRR) 74, Bankr. L. Rep. (CCH) P 78837, 16 A.L.R. Fed. 2d 801 (3d Cir. 2003)).

to have knowledge.<sup>416</sup> The Fourth Circuit expounded that *Mixon's* actual notice standard does not require actual knowledge of the transfer's voidability but, rather, in order to satisfy the actual notice standard, a transferee is required to have *actual knowledge of facts that would lead a reasonable person to believe that the transferred property was voidable*.<sup>417</sup> In so holding, the Fourth Circuit rejected CCM's argument that all that was required for a finding of good faith was an absence of actual knowledge.<sup>418</sup>

b. The Objective "Good Faith" Standard Under Section 550(b)

The Fourth Circuit next tackled the issue of whether the bankruptcy and district courts had applied the correct standard for determining good faith.<sup>419</sup> Those courts applied an objective standard in conducting their analysis of section 550(b).<sup>420</sup> The Fourth

<sup>416</sup>*Id.* (citing *In re Nordic Village, Inc.*, 915 F.2d 1049, 1055, 21 Bankr. Ct. Dec. (CRR) 1335, 23 Collier Bankr. Cas. 2d (MB) 1491, Bankr. L. Rep. (CCH) P 73650, 91-1 U.S. Tax Cas. (CCH) P 50028, 66 A.F.T.R.2d 90-5652 (6th Cir. 1990)) (quoting *Mixon*, 788 F.2d at 232 n.2).

<sup>417</sup>*Id.* (emphasis added). This standard was recently adopted by the United States Bankruptcy Court for the District of Massachusetts in *In re Bower*, where the court found that the assignee of an avoided mortgage (BNYMellon), a successor trustee to a securitized pool of mortgages who undoubtedly took for value, was not exempt from liability under section 550(b) of the Bankruptcy Code because a defect on the face of the mortgage rendered incredible BNYMellon's argument that it lacked knowledge of facts suggesting that the underlying transfer was avoidable which should have compelled it to investigate. *In re Bower*, 462 B.R. 347, 354-56, Bankr. L. Rep. (CCH) P 82143 (Bankr. D. Mass. 2012). As a point of note, in *Paloian*, LaSalle Bank did not argue it was a subsequent transferee who was exempt from liability as a good faith transferee pursuant to section 550(b) of the Bankruptcy Code. *See Paloian*, 619 F.3d at 691. The Seventh Circuit, did, however, observe that the trust's investors were persons "for whose benefit" the transfers were made, which would similarly render them unable to rely on section 550(b). *Id.* at 692.

<sup>418</sup>*Nieves*, 648 F.3d at 240.

<sup>419</sup>*Id.* at 238-42. In doing so, the Fourth Circuit noted that the Bankruptcy Code is not helpful in defining "good faith."

<sup>420</sup>The United States Court for the District of Maryland reached its definition of good faith by relying on a number of cases both within and outside of the Fourth Circuit, and held that good faith exists when a transferee lacks knowledge of circumstances that would cause a reasonable person to investigate. *In re Nieves*, 2007 WL 2915004, \*5 (Bankr. D. Md. 2007), order aff'd, 2008 WL 3989144 (D. Md. 2008), aff'd, 648 F.3d 232, 65 Collier Bankr. Cas. 2d (MB) 1442, Bankr. L. Rep. (CCH) P 82024 (4th Cir. 2011). The bankruptcy court held that an inquiry into good faith is not limited to actual knowledge from a subjective viewpoint, rather it should be based on an objective standard. *Id.* The District Court for the District of Maryland, in affirming, relied on *Mixon* and



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Circuit noted that the determination of the good faith standard under section 550(b) was an issue of first impression in the Fourth Circuit.<sup>421</sup> It found that both lower courts correctly held that good faith, for the purpose of section 550(b)(1) of the Bankruptcy Code, should be determined using an objective standard.<sup>422</sup> The Fourth Circuit further noted that in defining good faith, a court should analyze what the transferee knew or should have known, instead of examining the transferee's actual knowledge from a subjective position,<sup>423</sup> and observed that what a transferee "should have known" depends upon what the transferee actually knew, and not what the transferee was deemed to have known.<sup>424</sup> Thus, the Fourth Circuit concluded that if a transferee has knowledge sufficient to put him on inquiry notice of a debtor's possible insolvency, this knowledge would be enough to put the transfer at issue beyond the reach of section 550(b)'s good faith defense.<sup>425</sup>

Turning to the situation at hand, the Fourth Circuit found that CCM could not have taken the land in good faith because *CCM willfully ignored facts* that typically would have lead a lender, such as CCM, to inquire as to the background of the transfer and that cried out for investigation.<sup>426</sup> In doing so, the Fourth Circuit held that the bankruptcy court applied the correct legal standard

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other decisions from within the Fourth Circuit to reach the conclusion that the correct standard of "good faith" is an objective standard, and that just because a transferee lacks actual knowledge does not necessarily mean that such transferee has taken the land in good faith. *In re Nieves*, 2008 WL 3989144, \*3 (D. Md. 2008), *aff'd*, 648 F.3d 232, 65 Collier Bankr. Cas. 2d (MB) 1442, Bankr. L. Rep. (CCH) P 82024 (4th Cir. 2011).

<sup>421</sup>*Nieves*, 648 F.3d at 237.

<sup>422</sup>*Id.* at 238, 242.

<sup>423</sup>*Id.* at 239–40 (citing *In re Laines*, 352 B.R. 397, 406 (Bankr. E.D. Va. 2005)) (quoting *In re Sherman*, 67 F.3d 1348, 1355, 27 Bankr. Ct. Dec. (CRR) 1237, 34 Collier Bankr. Cas. 2d (MB) 655, Bankr. L. Rep. (CCH) P 76671 (8th Cir. 1995)).

<sup>424</sup>*Id.* at 239–40.

<sup>425</sup>*Id.*

<sup>426</sup>*Id.* at 241–42 (emphasis added). These circumstances included: (i) confusion over the actual legal name of 1st Financial; (ii) CCM's reliance on a month-old certificate of good standing; and (iii) CCM's inadequate title search to determine if 1st Financial was the true owner of the land. *Id.* Recently the Southern District of New York articulated a similar standard for the good faith defense under section 548(c) of the Bankruptcy Code which that court called "willful blindness." *See Picard v. Katz*, 462 B.R. 447, 55 Bankr. Ct. Dec. (CRR) 133, Bankr. L. Rep. (CCH) P 82077 (S.D. N.Y. 2011), motion to certify appeal denied, 466 B.R. 208, 55 Bankr. Ct. Dec. (CRR) 266 (S.D. N.Y. 2012); *see also* section III.B. of this article.

of good faith and that it did not view as clearly erroneous the bankruptcy court's finding that "facts known to CCM would have lead a 'lender under the circumstances of this case [to] inquire as to the possible records.'" <sup>427</sup> In adopting an objective good faith standard for purposes of section 550(b), the Fourth Circuit relied on its opinion in *In re Harbour* construing section 550(a) of the Bankruptcy Code. *In re Harbour* holds that an initial transferee must act in good faith as determined by an objective standard to be entitled to rely upon the mere conduit exception to liability. <sup>428</sup>

While the Fourth Circuit endorsed an objective standard for good faith, it clarified that good faith includes both an objective and subjective component. <sup>429</sup> Under the subjective component of good faith a court will look to the "honesty" and "state of mind" of the transferee. <sup>430</sup> Under the objective component a transferee does not act in good faith if it fails to abide by the typical routine business practices of the industry in which it operates. <sup>431</sup> Thus, the Fourth Circuit concluded that in determining good faith, a court will look at what a "transferee knew or should have known" while also taking into account the "customary practices of the industry in which the transferee operates." <sup>432</sup> Additionally, the Fourth Circuit stated that its holding was consistent with the good faith standard as it exists in other areas of commercial law and specifically in the Uniform Commercial Code. <sup>433</sup>

As part of its good faith analysis, the Fourth Circuit considered

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<sup>427</sup>*Nieves*, 648 F.3d at 241.

<sup>428</sup>*Id.* at 239 (citing *In re Harbour*, 845 F.2d 1254, 18 Collier Bankr. Cas. 2d (MB) 1214, Bankr. L. Rep. (CCH) P 72308, 92 A.L.R. Fed. 621 (4th Cir. 1988)). The Fourth Circuit also stated that other circuit courts have held similarly with respect to § 550(b). *Nieves*, 648 F.3d. at 238–39. See *In re Sherman*, 67 F.3d 1348, 27 Bankr. Ct. Dec. (CRR) 1237, 34 Collier Bankr. Cas. 2d (MB) 655, Bankr. L. Rep. (CCH) P 76671 (8th Cir. 1995); *In re Agricultural Research and Technology Group, Inc.*, 916 F.2d 528, 23 Collier Bankr. Cas. 2d (MB) 1517, Bankr. L. Rep. (CCH) P 73652 (9th Cir. 1990); *Bonded Financial*, 838 F.2d at 890. However, as noted in section III.C.1. of this article, the imposition of a "good faith" requirement to the "mere conduit" defense is somewhat controversial.

<sup>429</sup>*Nieves*, 648 F.3d at 239.

<sup>430</sup>*Id.* (citing *Triffin v. Pomerantz Staffing Services, LLC*, 370 N.J. Super. 301, 851 A.2d 100, 104, 53 U.C.C. Rep. Serv. 2d 927 (App. Div. 2004)).

<sup>431</sup>*Id.* (citing *Rudiger Charolais Ranches v. Van De Graaf Ranches*, 994 F.2d 670, 672–73, 20 U.C.C. Rep. Serv. 2d 912 (9th Cir. 1993)).

<sup>432</sup>*Id.* at 240.

<sup>433</sup>*Id.* at 239 (noting that both U.C.C. § 3-302 and § 1-304 apply similar standards of good faith).

whether a subsequent transferee is subject to the same standard of good faith as an initial transferee who seeks exemption from liability as a mere conduit. The Fourth Circuit again looked to *Harbour*, stating that its ruling in that case was instructive and determined that an objective standard of good faith will apply to all types of transferees and that an entity or person that wishes to be seen as taking in good faith cannot be willfully ignorant in the face of facts which “cry out for investigation.”<sup>434</sup>

c. Conclusion

The *Nieves* decision bolsters a shift towards an objective interpretation of the good faith requirement for the applicability of the safe harbor from avoidable transfers under section 550 of the Bankruptcy Code.<sup>435</sup> In addition, as a result of *Nieves*, at least in the Fourth Circuit, initial and subsequent transferees are all subject to the same good faith standard when it comes to section 550 of the Bankruptcy Code.

#### IV. SUMMARY

The recent decisions discussed above are likely the harbingers of a number of trends. While lenders had a short respite following *TOUSA II*, heightened diligence requirements for lenders who are receiving repayment of antecedent debt have been reinstated following the Eleventh Circuit’s recent reversal in *TOUSA III* of the district court’s determinations (a) that indirect and intangible benefits (including the opportunity to avoid an immediate bankruptcy) can be considered reasonably equivalent value and (b) that lenders who are repaid during the period leading up to a transferor’s bankruptcy would be considered subsequent transferees for purposes of section 550 of the Bankruptcy Code and not parties for whose benefit the liens securing a new loan were granted. With its decisions in *TOUSA III* and *Harwell*, the Eleventh Circuit has perhaps established its preference for interpretations of section 550 of the Bankruptcy Code that facilitate recovery for avoidable transfers. In addition, the decisions discussed indicate that the affirmative defense provided by sec-

<sup>434</sup>*Id.* (citing *In re Harbour*, 845 F.2d at 1258).

<sup>435</sup>Recently the United States Bankruptcy Court for the Southern District of New York cited *Nieves* when tackling the question of what is the proper standard for good faith under section 548(c) of the Bankruptcy Code. See *In re Dreier LLP*, 452 B.R. 391, 447–48 (Bankr. S.D. N.Y. 2011). Although noting that the determination of the proper legal standard for “good faith” under section 548(c) would have to wait for further developments in the case, the court noted that *Nieves* joined most courts in adopting an objective standard, albeit with respect to section 550(b). *Id.*

tion 548(c) will continue to be the subject of dispute, making it challenging for plaintiffs to succeed in dispositive motions when the good faith defense is asserted, particularly if more courts adopt a standard requiring a showing of the transferee's willful ignorance of facts relating to the fraudulent nature of the transfer in order to defeat the defense. Similarly, the affirmative defense contained in section 550(b) also will likely be the subject of further dispute due to uncertainty about the applicable standards for knowledge and good faith, as well as the factual context in which it is raised. The mere conduit theory for avoidance of initial transferee liability will inevitably be the topic of future decisions, not only because of its highly factual nature, but also because of the apparent divide between the circuits on the issues of whether a mere conduit is an initial transferee and whether a mere conduit must demonstrate its good faith when receiving a fraudulent transfer. The applicability of the section 546(e) safe harbor in actions seeking avoidance of constructively fraudulent transfers remains controversial and can involve high stakes, as demonstrated in the decisions in avoidance actions commenced in the BLMIS liquidation proceedings.

The cases discussed also provide warnings for both trustees of securitized investment pools and attorneys who allow distressed parties to make transfers through their trust accounts. Attorneys may not simply hide behind their fiduciary role when accepting and distributing funds from their trust accounts. Trustees of securitized pools of assets should be aware of their potential fraudulent transfer liability as initial transferees under section 550(a) of the Bankruptcy Code (and reminded to assert their status as subsequent transferees when possible), but it appears that entities acting solely as agents to financing facilities may be able to successfully invoke the mere conduit defense to initial transferee liability.