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# **Fraudulent Transfers and the Subsequent Transferee Defense Under the Bankruptcy Code and UFTA / UVTA**

Meeting or Overcoming the Defense for Subsequent Transferees of Payments From the Debtor

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TUESDAY, OCTOBER 18, 2016

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Today's faculty features:

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Royer Cooper  
Cohen Braunfeld LLC

***Fraudulent Transfers and the  
Subsequent Transferee Defense Under  
the Bankruptcy Code and UFTA / UVTA***

**Marc E. Hirschfield, Partner**

**Marc Skapof, Partner**

Strafford Webinars

October 18, 2016

1:00 p.m. – 2:30 p.m.

## Disclaimer

- Mr. Hirschfield and Mr. Skapof were previously counsel to the Madoff Trustee at a previous firm. Therefore, we will not and cannot speak about any existing Madoff litigation.
- Our opinions are ours and not necessarily those of Royer Cooper Cohen Braunfeld LLC.

# Introduction to Avoidance and Recovery Liability and Defenses

The Bankruptcy Code separates the concepts of avoidance and recovery. Bankruptcy Code sections 544, 547, 548 and 549 authorize bankruptcy trustees and DIPs to avoid certain pre- and post-petition transfers to creditors and others.

# Introduction to Avoidance and Recovery Liability and Defenses (*cont.*)

- Bankruptcy Code section 550 governs the recovery of avoided transfers or their value.
- Section 550(a) provides that the debtor “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.”



# Introduction to Avoidance and Recovery Liability and Defenses (*cont.*)

Section 550 distinguishes between initial transferees and subsequent transferees.

- Initial transferees receive the transfer directly from the debtor or the transfer is made for the initial transferee's benefit. "For the benefit," can be very technical, with important pleading consequence which we will discuss later in presentation.
- A subsequent transferee can be the recipient of the transfer from the initial transferee or a preceding subsequent transferee.



# Introduction to Avoidance and Recovery Liability and Defenses (*cont.*)

Once the a transfer is avoided, it can be traced down the line to any subsequent transferee and recovered so long as properly traced, even if commingled with other funds.

# Introduction to Avoidance and Recovery Liability and Defenses (*cont.*)

- Courts have adopted various tests to aid debtors in tracing transfers in commingled bank accounts, which include without limitation:
  - the “first in, first out” test
  - the “last in, first out” test
  - the “lowest intermediate balance” rule
- Other tests may apply in other contexts.
- Certain tracing rules have been restated in the Restatement of Restitution and Unjust Enrichment

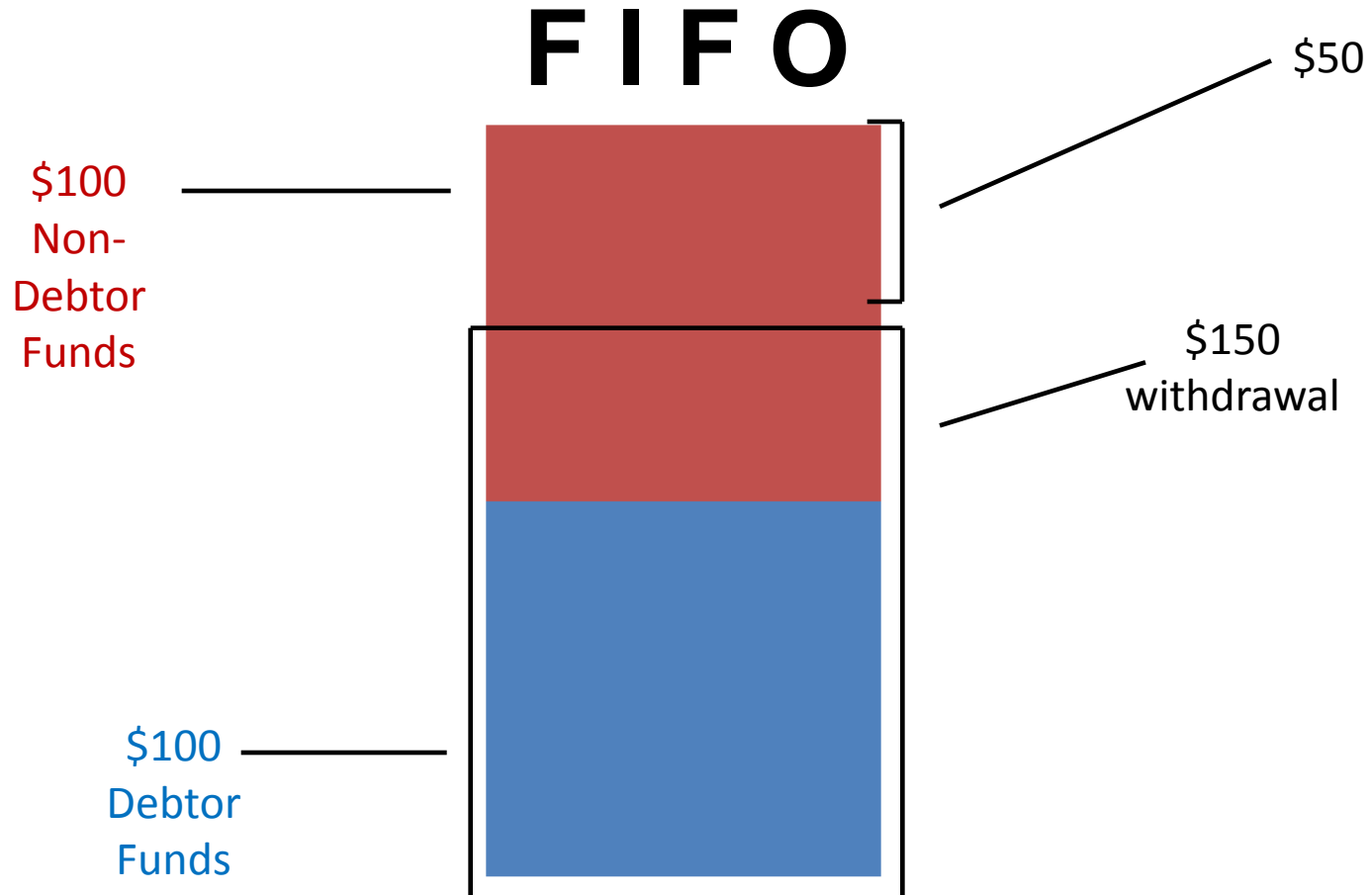
# Introduction to Avoidance and Recovery Liability and Defenses (*cont.*)

The following hypothetical will be used to illustrate the application of “first in, first out” and “last in, first out” tests:

- (1) Seller gets a \$100 payment from Company for a shipment of widgets.
- (2) Seller puts the \$100 into a concentration account and then puts in \$100 of payments from other customers.
- (3) Seller then withdraws \$150 from the concentration account to pay a dividend to Equity Holder.
- (4) Company files for Chapter 11 bankruptcy shortly afterwards and the debtor-in-possession seeks to avoid and recover the \$100 payment from (x) Seller as the initial transferee and (y) from Equity Holder as the subsequent transferee.

# Introduction to Avoidance and Recovery Liability and Defenses (*cont.*)

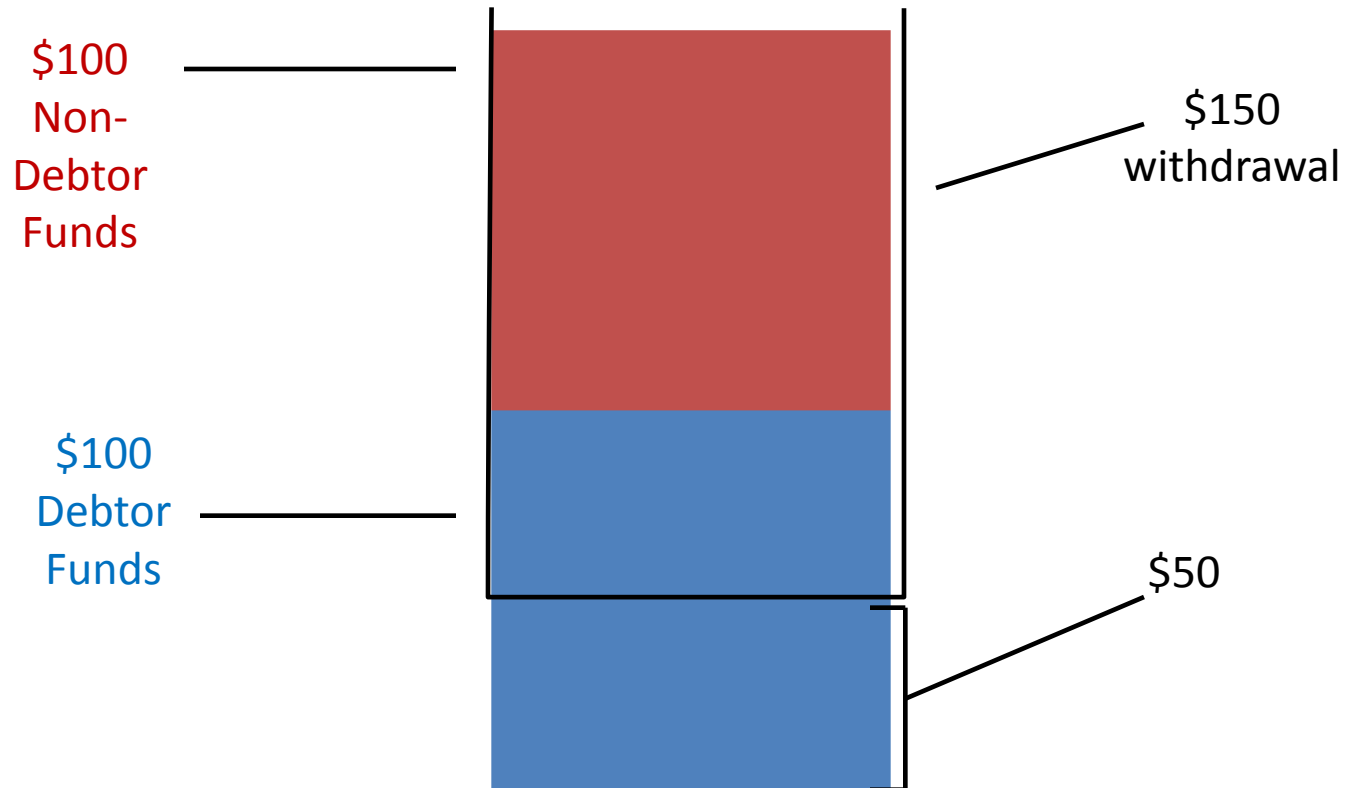
- The “first in, first out” test provides that the first funds withdrawn from a commingled account correspond to the first funds put in, and all subsequent withdrawals correspond to the funds put in thereafter in the order that they were put in.
- In the hypothetical, \$100 of the funds paid by Seller to Equity Holder would be traceable to the debtor because (1) the \$100 payment from the debtor was the first funds put into the account, and (2) the \$150 withdrawal is deemed to be made from the first funds in the account.



# Introduction to Avoidance and Recovery Liability and Defenses (*cont.*)

- The “last in, first out” test used in the context of making distributions from a commingled account to depositors who are owed the return of their funds. It would require that the entities that most recently put in money receive distributions of their funds first, followed by other creditors in the inverse order of when they paid into the account.
- In the hypothetical, only \$50 of the funds paid by Seller to Equity Holder would be traceable to the debtor because (1) the \$100 payment from the debtor was the first funds put into the account, and (2) the \$150 withdrawal is deemed to be made from the last funds in the account.

# LIFO





# Introduction to Avoidance and Recovery Liability and Defenses (*cont.*)

The “lowest intermediate balance” rule (LIBR) applies most often in the context where trust funds have been put into commingled accounts.

- It treats withdrawals from the account as made first against the funds not held in trust.
- For example, if the account balance is greater than or equal to the amount of trust funds, the entire amount of the trust funds are considered traceable to the account.
- Once the trust funds are withdrawn, those funds are no longer considered traceable to the particular account even if the account’s balance is later replenished with other unrelated funds.
- Therefore, the party seeking the return of the funds may only recover from the accountholder up to the amount of the lowest balance the account ever held between the time the funds were put in and the action to recover them.

# Introduction to Avoidance and Recovery Liability and Defenses (*cont.*)

The following hypothetical illustrates how the LIBR is applied: Law Firm gets \$100 in trust from Client to be paid as settlement funds once a dispute in which Law Firm represents Client is resolved. Law Firm puts the \$100 payment into an IOLTA and then improperly puts in \$100 from another client for payment of services. Law Firm then improperly withdraws \$100 from the IOLTA to pay an equity distribution to Partner. Client files for Chapter 11 bankruptcy shortly afterwards and the debtor-in-possession seeks to avoid and recover the trust funds from Law Firm as the initial transferee and from Partner as the subsequent transferee.

- The LIBR will assume Law Firm withdrew the non-trust funds, so that the debtor can trace the \$100 of trust funds to the remaining balance in the account.
- Now say Law Firm withdraws \$125 to pay Partner. The LIBR will consider only the \$75 remaining on deposit in the account to consist of traceable funds. Because \$25 of the trust funds have left the account, the LIBR no longer considers these funds traceable.

# Introduction to Avoidance and Recovery Liability and Defenses (*cont.*)

Section 550(b) provides defenses to recovery liability for subsequent transferees. Section 550(b)(1) provides a defense to a transferee who “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 . . . .” Section 550(b)(2) extends this defense to “any immediate or mediate good faith transferee of such transferee.”

- Section 550(b)(1) requires a subsequent transferee to show (1) good faith and (2) value
- Section 550(b)(2) extends this defense to transferees further down the chain.

# Introduction to Avoidance and Recovery Liability and Defenses (*cont.*)

These defenses are designed to be consonant with the non-bankruptcy policy of protecting *bona fide* purchasers (BFP) for value or holders in due course from having to disgorge funds or their value based on the knowledge of the initial transferee.

# Introduction to Avoidance and Recovery Liability and Defenses (*cont.*)

- The Uniform Fraudulent Transfer Act section 8(b)(2) is the state-law equivalent of section 550(b). It protects transferees to the extent the transferees gave “value” in good faith.
- A minority of states, like New York, have codified the older Uniform Fraudulent Conveyance Act, which also protects good-faith transferees that provide value for the transfer. (See N.Y. Debtor & Creditor Law section 278(1) (“Where a conveyance . . . is fraudulent as to a creditor, such creditor, . . . may” recover “as against any person *except a purchaser for fair consideration without knowledge of the fraud at the time of the purchase . . . .*”) (emphasis added).)

## Discussion of key subsequent transferee defenses issues - Value

- “Value” is an affirmative defense; a transferee relying on the defense has the burden of proof.
- “Value” for subsequent transferees is measured against the initial transferee and not the debtor like in the initial transferee context.
- Looks to what the transferee gave up rather than what the transferor or any prior transferor, including the debtor, received. *Bonded Fin. Servs., Inc. v. European Am. Bank*, 838 F.2d 890 (7th Cir. 1988); see *Genova v. Gottlieb (In re Orange County Sanitation, Inc.)*, 221 B.R. 323 (Bankr. S.D.N.Y. 1997).

# Discussion of key subsequent transferee defenses issues – Value (*cont.*)

- The transferee next in the chain after the initial transferee (the secondary transferee) must show that it gave value to invoke the section 550(b) defense.
- However, any subsequent transferee of a subsequent transferee that gave value need only receive the transfer in good faith. There is no requirement for a transferee at the third tier or beyond to give value, consistent with treating such a transferee as a BFP.

# Discussion of key subsequent transferee defenses issues – Value (*cont.*)

- Value is not defined in the Bankruptcy Code and is a highly fact-based analysis.
- Transactions that satisfy, discharge or secure all or part of an otherwise legitimate obligation are for "value." For example, the repayment of a loan.



# Discussion of key subsequent transferee defenses issues – Value (*cont.*)

Transactions that are gifts or other gratuitous transfers do not give value as a matter of law. As a general rule, these include:

- Outright gifts. See e.g., *Youngblut v. Pepmeyer (In re Pepmeyer)*, 275 B.R. 539, 545 (Bankr. N.D. Iowa 2002) (debtor received no value in gifting ownership of an annuity to his daughter)
- Property passing under a will. See *Gray v. Snyder*, 704 F.2d 709 (4th Cir. 1983) (no value could be assigned to release of inheritance rights by the transferee-spouse)

# Discussion of key subsequent transferee defenses issues – Value (*cont.*)

Transactions that do not give value (*cont.*):

- Corporate dividends. See *Pereira v. Equitable Life Ins. Society (In re Trace Int'l Holdings, Inc.)*, 289 B.R. 548, 560–61 (Bankr. S.D.N.Y. 2003) (dividends paid from an insolvent corporation to shareholders were made for no value and therefore, were fraudulent conveyances).
- Guaranties in which the debtor obliges itself to pay the debts of another. See *In re R.M.L., Inc.*, 195 B.R. 602, 618 (Bankr. M.D. Pa. 1996)
- Charitable contributions, such as tithes and offerings to a church, to the extent avoidable. See *In re Lewis*, 401 B.R. 431, 436 (Bankr. C.D. Cal. 2009) (collecting cases)
- College Tuition Paid by Parent for Adult Child, Courts split. See *Gold v. Marquette*, 454 B.R. 444, 457 (Bankr. E.D. Mich. 2011). (no value) vs. *DeGiacomo v. Sacred Heart University, Inc. (In re Palladino)*, Adv. Pro. No. 15-01126, 2016 Bankr. LEXIS 2938 (Bankr. Mass. Aug. 10, 2016), (value given)

# Discussion of key subsequent transferee defenses issues – Value (*cont.*)

Courts have crafted three tests to determine whether a subsequent transferee has provided value:

- (1) contract sufficiency,
- (2) reasonably equivalent value, and
- (3) fair market value

# Discussion of key subsequent transferee defenses issues – Value (*cont.*)

## Contract Sufficiency

Majority rule Under section 550(b), a subsequent transferee must provide “merely consideration sufficient to support a simple contract . . .” to its transferor. See 5 COLLIER ON BANKRUPTCY ¶ 550.03[1] (16th ed. 2015); *Lewis v. Zermano (In re Stevinson)*, 194 B.R. 509, 513 (D. Colo. 1996); *In re Commercial Loan Corp.*, 396 B.R. 730, 743 (Bankr. N.D. Ill. 2008).

# Discussion of key subsequent transferee defenses issues – Value (*cont.*)

## Contract Sufficiency (*cont.*)

- Does not require that value given by the transferee be reasonable or a fair equivalent.
- Analogous to the “value” required under state law to achieve the status of a *bona fide* purchaser for value. *See Redmond v. Brooke Holdings, Inc. (In re Brooke Holdings, Inc.)*, 515 B.R. 632 (Bankr. D. Kan. 2014) (only value needed for section 550(b), without regard to its equivalence to the transfer, is value akin to the protections for purchasers of goods under the Uniform Commercial Code).

# Discussion of key subsequent transferee defenses issues – Value (*cont.*)

## Reasonably Equivalent Value

- In the initial transferee context, the reasonably equivalent value test requires a court to “examine the totality of the circumstances surrounding the transfer in question.” *Pereira v. WWRD US, LLC (In re Waterford Wedgwood USA, Inc.)*, 500 B.R. 371, 381 (Bankr. S.D.N.Y. 2013).
- The factors considered are “(i) the fair market value of the economic benefit received by the debtor [from the transferee]; (ii) the arms-length nature of the transaction; and (iii) the good faith of the transferee.” *Pereira*, 500 B.R. at 381.

# Discussion of key subsequent transferee defenses issues – Value (cont.)

## Reasonably Equivalent Value (cont.)

- A dollar-for-dollar exchange is not required. Courts instead examine the transaction to see if the transfer was for “roughly” the amount received.
- For subsequent transferees, it may be appropriate to view multiple transfers separately to determine whether value was provided for purposes of section 550(b). *See Rodgers v. Monaghan Co. (In re Laguna Beach Motors, Inc.)*, 159 B.R. 562, 569 (Bankr. C.D. Cal. 1993) (viewing two separate payments independently in determining section 550 defense).

# Discussion of key subsequent transferee defenses issues – Value (*cont.*)

## Fair Market Value

- Used by courts either as a subset of the reasonably equivalent value test or as a stand-alone test of value.
- *Brown v. Harris (In re Auxano, Inc.)*, 96 B.R. 957, 965 (Bankr. W.D. Mo. 1989) adopted the fair market value measurement after considering what the subsequent transferee parted with and the purpose of the avoidance and recovery powers to preserve assets of the estate.



# Discussion of key subsequent transferee defenses issues - other

## FBO defendant versus subsequent transferee

*Section 550(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 [debtor] 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.

# Discussion of key subsequent transferee defenses issues – other (*cont.*)

## FBO defendant versus subsequent transferee (*cont.*)

- Section 550 provides for recovery from (1) an initial transferee, (2) an entity for whose benefit the transfer was made, who is considered a subset of a direct “initial transferee”, or (3) a subsequent transferee.
- See *In re M. Blackburn Mitchell Inc.*, 164 B.R. 117, 130 (Bankr. N.D. Cal. 1994) (“Under § 550(a)(1), *both* entities are liable”-referring to “entity for whose benefit” and “transferee”); *In re The Heritage Org., LLC*, 413 B.R. 438, 499 (Bankr. N.D. Tex. 2009).
- Section 550 does not allow recovery of an avoided transfer *for the benefit of a subsequent transferee*.

# Discussion of key subsequent transferee defenses issues – other (*cont.*)

## FBO defendant versus subsequent transferee (*cont.*)

*Hypothetical:* Debtor pays Uncle for purpose of paying Niece's college tuition. Uncle transfers funds to College for tuition for Niece. Debtor can recover from Uncle (entity to whom transfer was made), Niece (entity for whose benefit transfer was made), or College (subsequent transferee).

*College Tuition Cases:* Pursuit of colleges as initial transferees based on payment of child's tuition may give college a defense that the child was the initial transferee because child obligated to college such that child "FOB" transferee. Raises value and statute of limitations issues. 35

# Discussion of key subsequent transferee defenses issues – other (*cont.*)

## Recovery from either initial transferee or subsequent transferee

- The debtor is entitled to recover an avoided transfer either from initial transferee *or* the subsequent transferee. *Both* are liable for the transfer or its value.
- *See e.g., In re Circuit Alliance, Inc., 228 B.R. 225, 236 (Bankr. D. Minn. 1998) (the Bankruptcy Code “contemplates a joint suit against both initial transferee and converting beneficiary, as well as all subsequent transferees not entitled to the defense of § 550(b)”)*

# Discussion of key subsequent transferee defenses issues – other (*cont.*)

## Recovery from either initial transferee or subsequent transferee (*cont.*)

- However, the debtor is limited to a single satisfaction under section 550(d)
- Section 550(d): “[the debtor] is entitled to only a single satisfaction under subsection (a) of this section.”
- See *In re Prudential of Florida Leasing, Inc.*, 478 F.3d 1291 (11th Cir. 2007) (under section 550(d), debtor was limited to a single recovery for each transfer).

# Discussion of key subsequent transferee defenses issues – other (*cont.*)

## Recovery from either initial transferee or subsequent transferee (*cont.*)

- The Bankruptcy Code does not provide an express or implied right to an initial transferee to seek indemnity or contribution from a subsequent transferee or beneficiary of the transfer.
- See *In re Agra-By-Products, Inc.*, No. 82-05701, 1985 WL 660781, at \*1 (Bankr. D.N.D. Aug. 1, 1985); *In re Schick*, 223 B.R. 661, 663 (Bankr. S.D.N.Y. 1998); *In re Dunhill Resources, Inc.*, 2006 WL 2090208, at \*3 (Bankr. S.D. Tex. June 27, 2006) (dismissing alleged initial transferee's third-party complaints seeking indemnity or contribution for sums the debtor sought to collect as fraudulent transfers).

# Discussion of key subsequent transferee defenses issues – other (*cont.*)

## Recovery from either initial transferee or subsequent transferee (*cont.*)

- However, courts have recognized that initial transferees may seek contribution or indemnity from subsequent transferees or visa-versa under other applicable law, such as agency law or by agreement. *See e.g., Agra-By-Products*, 1985 WL 660781, at \*1.
- Such actions are not within the bankruptcy court's jurisdiction. *See In re Pearson Indus., Inc.*, 142 B.R. 831 (Bankr. C.D. Ill. 1992) (dismissing for lack of jurisdiction initial transferee's third-party complaint seeking indemnity or contribution for transfer from subsequent transferee).

# Discussion of key subsequent transferee defenses issues – other (*cont.*)

## Recovery from either initial transferee or subsequent transferee (*cont.*)

- Under section 502(h), a subsequent transferee from whom the debtor recovers a transfer under section 550 may pursue a claim against the bankruptcy estate as if such claim were a prepetition claim. See *Southmark Corp. v. Schulte, Roth & Zabel, LLP*, 242 B.R. 330, 341 (N.D. Tex. 1999).
- Claims traders: should be aware that they may be liable for the transfer with the initial transferee subject to any defenses, such as a value defense



# Discussion of key subsequent transferee defenses issues – other (*cont.*)

## Subsequent transferee may raise initial transferee defenses

- Section 550 allows recovery of a transfer only “to the extent that a transfer is avoided.”
- Some courts have interpreted this to require a successful avoidance action against the initial transferee before the debtor may recover from a subsequent transferee.

# Discussion of key subsequent transferee defenses issues – other (*cont.*)

## Subsequent transferee may raise initial transferee defenses (*cont.*)

- However, the majority view is that a transfer may be found avoidable and a recovery may be had from a subsequent transferee without first suing the initial transferee.
- In an action against the subsequent transferee, the debtor has the burden of proving that the transfer to the initial transferee is avoidable.

# Discussion of key subsequent transferee defenses issues – other (*cont.*)

## Subsequent transferee may raise initial transferee defenses (*cont.*)

- The subsequent transferee is not collaterally estopped from litigating the avoidability of the transfer merely because it is a subsequent transferee. See *Off. Comm. of Unsecured Creditors of M. Fabrikant & Sons, Inc. v. JP Morgan Chase Bank, N.A. (In re M. Fabrikant & Sons, Inc.)*, 394 B.R. 721, 746 (Bankr. S.D.N.Y. 2008).
- Absent collateral estoppel or *res judicata*, a subsequent transferee may raise any and all defenses to avoidance and recovery available to the initial transferee, including that the transfer was not avoidable or that the transferee did not have knowledge of the voidability of the transfer under section 550(b)(1). See *Tibble v. Farmers Grain Express, Inc. (In re Michigan Biodiesel, LLC)*, 510 B.R. 792, 799 (Bankr. W.D. Mich. 2014)

# Discussion of key subsequent transferee defenses issues – other (*cont.*)

## Subsequent transferee may raise initial transferee defenses (*cont.*)

- For example, if initial transferee has settled with the debtor for less than the total amount sought to be recovered, the subsequent transferee defendant may assert defenses available to the initial transferee, even if the initial transferee did not raise those defenses. See *In re Flashcom, Inc.*, 361 B.R. 519, 525 (Bankr. C.D. Cal. 2007) (stipulated or default judgment in avoidance action does not preclude defendants in recovery action from disputing the avoidability of the transfer or raising appropriate defenses).
- However, because of the single satisfaction rule, the subsequent transferee is only liable for the remaining balance of the transfer sought to be recovered.

# Discussion of key subsequent transferee defenses issues – other (*cont.*)

## Subsequent transferee may raise initial transferee defenses (*cont.*)

- Likewise, if an initial transferee has failed to raise a given defense, the subsequent transferee may raise that defense.
- This is a matter of due process because the subsequent transferee may not have been involved in the litigation to avoid the initial transfer.

# Discussion of key subsequent transferee defenses issues – other (*cont.*)

## Statute of Limitations on Recovery

- Section 550 contains its own statute of limitations.
- Subsection (f) provides that an action to recover under section 550 must be brought no later than the earlier of:
  - one year after the transfer was avoided or
  - the date the case is closed or dismissed.

# Discussion of key subsequent transferee defenses issues – other (*cont.*)

## Statute of Limitations on Recovery (*cont.*)

- Debtors will usually, but not always, file a consolidated action to avoid the transfer and recover the property transferred or its value.
- But where the debtor does not know the identity of, or even if there was a subsequent transferee, the debtor can start with the initial transferee and then use the section 550(f) statute of limitations once that initial transfer is avoided.

# Discussion of key subsequent transferee defenses issues – other (*cont.*)

## Statute of Limitations on Recovery (*cont.*)

- A settlement (subject to the single satisfaction rule) with the initial transferee triggers the section 550(f) statute of limitations. See *ASARCO LLC v. Shore Terminals LLC*, No. 11-01384, 2012 WL 2050253, at \*5 (N.D. Ca. June 6, 2012).
- Courts have reasoned that, if a settlement did not trigger section 550(f), the statute of limitations would be indefinite because a trigger event, i.e., the initial avoidance, may never occur.



# Discussion of key subsequent transferee defenses issues – other (*cont.*)

Automatic stay of concurrent state-law fraudulent transfer claims: *In re Tribune Co. Fraudulent Conveyance Litigation*, 399 B.R. 310 (S.D.N.Y. 2013)

- The unsecured creditors' committee in the *Tribune* chapter 11 case brought adversary proceedings asserting actual fraudulent transfer claims against the debtor's cashed-out shareholders, directors / officers, and others who benefitted from a prepetition LBO of the debtor.
- Individual creditors then brought actions asserting state-law constructive fraudulent conveyance claims to unwind buyouts of the debtor's shareholders.
- The actions were consolidated into a multi-district litigation and defendants moved to dismiss individual creditor actions.

# Discussion of key subsequent transferee defenses issues – other (*cont.*)

## Automatic stay of concurrent state-law fraudulent transfer claims (*cont.*)

- The district court granted the motion. It held that the individual creditors lacked standing to bring fraudulent transfer claims targeting the same transactions the committee was targeting.
- The automatic stay deprived the individual creditors from bringing state-law fraudulent conveyance claims, despite the fact that the unsecured creditors' committee was asserting an actual fraud theory and the individual creditors were asserting a constructive fraud theory.

# Discussion of key subsequent transferee defenses issues – other (*cont.*)

## Automatic stay of concurrent state-law fraudulent transfer claims (*cont.*)

- However, the district court also found that limitations on some of the of the debtor's avoiding powers under section 546 of the Code did not preempt the state-law claims.
- The language of that section did not provide for preemption because it expressly imposed those limitations on a "trustee," which in a Chapter 11 case means a debtor-in-possession, and not other parties with standing and thus there was no preemption under the Supremacy Clause.
- The court recognized the risk that bankruptcy trustees will simply assign section 544(a) claims to creditors if barred by section 546(a), but reasoned that the concerns were overstated in light of the fact that the automatic stay bars state-law fraudulent conveyance claims brought concurrently with the debtor so that the bankruptcy court would still retain some control.

- *Tribune* Affirmed by Second Circuit, *In re Tribune Co. Fraudulent Conveyance Litigation*, No. 13-3992 (2d Cir. 2016).
- Court explained that “the regulation of creditors’ rights has ‘a history of significant federal presence’” and that “once a party enters bankruptcy, the Bankruptcy Code constitutes a wholesale preemption of state laws regarding creditors’ rights.”
- Court explained that the Creditors’ core theory (i.e., Section 546(e)’s use of the word “trustee” meant that it did not apply to creditors’ claims) raised “ambiguities, anomalies, or conflicts with the purposes of the Code.”
- Court explained that Section 546(e) was intended to protect settled securities transactions from disruption and that this protection is “essential to securities markets.”

- Delaware Court in Recent Decision Breaks with Second Circuit: *AH Litig. Trust v. Water Street Healthcare Partners, L.P. (In re Physiotherapy Holdings, Inc.)*, No. 15-51238 (KG), 2016 WL 3611831 (Bankr. D. Del. June 20, 2016)
- In context of a going private LBO, Court examined whether the purpose of section 546(e) would be thwarted by allowing the Trust to pursue its state fraudulent transfer claims against the defendants.
- Rejected preemption because the action targeted two controlling shareholders of a non-public corporation so it was difficult for the Court to envision any ripple effect on the market.
- Second, the Trust brought the actions as a creditor-assignee, not as an estate representative – a scenario not addressed by Congress in section 546(e) despite its ability to do so.
- Third and finally, the defendants were alleged to have acted in both faith and thus, dismissal of the action would undermine other overarching policy objectives of the Bankruptcy Code targeted at ensuring a fair distribution of assets and protecting creditors from shareholder wrongdoing.

## ***Klein v. King & King & Jones, No. 13-4131, 571 F.App'x 702 (10<sup>th</sup> Cir. July 14, 2014)***

- A receiver for an investment trust that operated as a Ponzi scheme brought an action against a law firm under the Utah Uniform Fraudulent Transfers Act (UFTA) to recover funds that the trust paid for an individual's defense against a state-court criminal charge.
- The law firm argued that it received the payments for value because it provided legal services to the individual criminal defendant. The district court rejected this argument and granted summary judgment to the receiver.

# ***Klein v. King & King & Jones, No. 13-4131, 571 F.App'x 702 (10<sup>th</sup> Cir. July 14, 2014***

The 10th Circuit Court of Appeal affirmed. It reasoned that the good-faith transferee defense in the Utah UFTA wasn't available to the law firm because:

- (1) the trust did not receive “reasonably equivalent value” for the funds transferred to the law firm; and
- (2) the law firm was an initial and not a subsequent transferee of funds and hence defenses available to subsequent transferees did not apply.

# ***Klein v. King & King & Jones*, No. 13-4131, 571 F.App'x 702 (10<sup>th</sup> Cir. July 14, 2014)**

- Transferee defense in Utah UFTA: “A transfer . . . is not voidable . . . against a person who took in good faith and for a reasonably equivalent value or against any subsequent transferee . . . .” Utah Code Ann. § 25-6-9(1).
- A subsequent transferee who is “a good faith transferee who took for value” also has a defense. Utah Code Ann. § 25-6-91(2)(b).



# ***Klein v. King & King & Jones, No. 13-4131, 571 F.App'x 702 (10<sup>th</sup> Cir. July 14, 2014) (cont.)***

## Tenth Circuit's Rulings:

- Reasonably equivalent value
  - Required to give value *to the debtor*
  - Law firm's legal services did not benefit anyone but the individual criminal defendant.
- Initial transferee v. subsequent transferee
  - Firm received funds directly from trust and thereby was the initial transferee
  - Defenses available to subsequent transferees hence not available.

# Uniform Voidable Transactions Act

The Uniform Fraudulent Transfers Act is the model act adopted by many states to authorize avoidance and recovery of fraudulent transfers. UFTA section 8 sets forth the defenses to avoidance and recovery:

*(a) A transfer or obligation is not voidable under Section 4(a)(1) against a person who took in good faith and for a reasonably equivalent value or against any subsequent transferee or obligee.*

*(b) Except as otherwise provided in this section, to the extent a transfer is voidable in an action by a creditor under Section 7(a)(1), the creditor may recover judgment for the value of the asset transferred, as adjusted under subsection (c), or the amount necessary to satisfy the creditor's claim, whichever is less. The judgment may be entered against:*

*(1) the first transferee of the asset or the person for whose benefit the transfer was made; or*

*(2) any subsequent transferee other than a good faith transferee who took for value or from any subsequent transferee.*

# Uniform Voidable Transactions Act (*cont.*)

- Under the UFTA section 8(a), a transfer made with the intent to hinder, delay, or defraud a creditor is not voidable if a transferee takes the transfer in good faith and for reasonably equivalent value.
- As originally written, the transferee did not need to show that it gave value *to the debtor* for the transfer.

# Uniform Voidable Transactions Act (*cont.*)

- There is no equivalent defense to avoidance in the Bankruptcy Code, which requires a showing of good-faith and value *to the debtor*.
  - Section 548(c): Except to the extent that a transfer . . . voidable under this section is voidable under section 544, 545, or 547 of this title, a transferee . . . of such a transfer . . . that takes for value and in good faith has a lien on or may retain any interest transferred . . . to the extent that such transferee . . . gave value *to the debtor* in exchange for such transfer . . . . (Emphasis added.)
- Under the UFTA, any subsequent transferee who took the transfer in good faith and for value also has a defense. (UFTA § 8(b)(2).)

# Uniform Voidable Transactions Act (*cont.*)

The Uniform Law Commission has recently promulgated revisions to the UFTA and changed the name of the model act to the Uniform Voidable Transactions Act (UVTA). The UVTA made two significant amendments to the defenses to avoidance and recovery:

- Limited the value defense to avoidance to value given to the debtor
- Expanded the value defense to recovery so that it applies to recovery of or from the transferred property or its proceeds

# Uniform Voidable Transactions Act (*cont.*)

## Amendment 1: Limited value defense to avoidance to value given to the debtor

UVTA section 8 (as redlined against the UFTA) provides:

- (a) A transfer or obligation is not voidable under Section 4(a)(1) against a person ~~who~~ that took in good faith and for a reasonably equivalent value given to the debtor or against any subsequent transferee or obligee.
- (b) To the extent a transfer is avoidable in an action by a creditor under Section 7(a)(1), the following rules apply:
  - ~~(1)~~ Except as otherwise provided in this section, ~~to the extent a transfer is voidable in an action by a creditor under Section 7(a)(1),~~ the creditor may recover judgment for the value of the asset transferred, as adjusted under subsection (c), or the amount necessary to satisfy the creditor's claim, whichever is less. The judgment may be entered against:
    - (i) the first transferee of the asset or the person for whose benefit the transfer was made;  
or
    - ~~(2)~~ (ii) any subsequent transferee an immediate or mediate transferee of the first transferee, other than a good faith transferee who took for value or from any subsequent transferee.
      - (A) a good faith transferee ~~who~~ that took for value, or from
      - ~~(B)~~ any subsequent transferee any immediate or mediate good-faith transferee of a person described in clause (A).

# Uniform Voidable Transactions Act (*cont.*)

## Amendment 1: Limited value defense to avoidance to value given to the debtor (cont.)

- This amendment limits the value defense to avoidance to value given *to the debtor*.
- Applies to any defendant against who the debtor is seeking to avoid the transfer, which is typically the initial transferee but may be a subsequent transferee

# Uniform Voidable Transactions Act (*cont.*)

## Amendment 1: Limited value defense to avoidance to value given to the debtor (cont.)

- This amendment further aligns the defense to avoidance in state fraudulent transfer law with the defense in the Bankruptcy Code.
- This amendment does not alter the defense to recovery under UFTA, under which defendants need only show good faith and value to the transferor (such as the initial transferee). (See UFTA § 8(b)(1)(ii).)



# Uniform Voidable Transactions Act (*cont.*)

## Amendment 2: Expanded value defense to recovery of or from the transferred property or its proceeds

- Under the UFTA, the defense for a subsequent transferee that took in good faith and for value (and for a subsequent transferee of that transferee) literally applied only to an action for money judgment
- The UVTA provides that that defense also applies to recovery of or from the transferred property or its proceeds, by levy or otherwise.
- This amendment is consistent with section 550 of the Bankruptcy Code

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