AMERICAN BANKRUPTCY INSTITUTE

Southeast Bankruptcy Workshop

Advanced Fraudulent Transfers: A Baker's Dozen of Helpful Tips and Insights

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CONCURRENT SESSION

2022

27th Annual Southeast Bankruptcy Workshop
July 21-24, 2022, Amelia Island, Florida

Advanced Fraudulent Transfers

Considerations in Analysis of Solvency and Capital Adequacy:
Assessment of Pre-Transfer Projections, Fairness and Solvency Opinions

Report Comparison

Valuations

- An opinion of the "value" of a business, business interest, asset, or debt instrument for a stated purpose as of a certain date
- Historical value
- Reasonably equivalent value in exchange
- "Current" or "prospective" value for confirmation, DIP loans, §363 sale, etc.

Solvency Opinions

- An opinion of a company's "solvency" after giving effect to a proposed transaction under specified terms and considering economic conditions
- 3 solvency tests
- Availability of surplus for distributions
- Leveraged buyouts
- Debt refinancing

Fairness Opinions

- An opinion of whether the financial terms of a transaction are "fair" to shareholders based on certain assumptions as of a specific date
- M&A
- Buy-backs
- Related-party
- Transactions involving noncash consideration

Primary Components of Analysis

- Projections
- Risk
- Capital Structure
- Comparable Company Transactions
- Benchmark Performance Data

Primary Components of Analysis

Projections

- Consideration of historical performance
- Operational changes
- Changes in leverage and interest rates
- Growth rate(s)
- Capital expenditures and working capital requirements
- Variations in assumptions for multiple product/service lines

Primary Components of Analysis

Risk

- Performance Risk – Likelihood of meeting projections
  - Products
  - Market
  - Technology
  - Regulation
- Economic Risk – Impact of local, national and global economic issues on the company individually or the industry on whole
- Comparative Risk – Risk of investment in the company vs. other available investments (i.e., U.S. Treasuries, stock market)

Primary Components of Analysis

Capital Structure

- Asset liquidity vs. illiquidity (e.g., intangible assets)
- Leverage
  - Amount and timing of payments (current and future)
  - Covenants and other restrictions
  - Access to financing
- Existence of Contingent Assets/Liabilities (for solvency analysis)
  - Guarantees

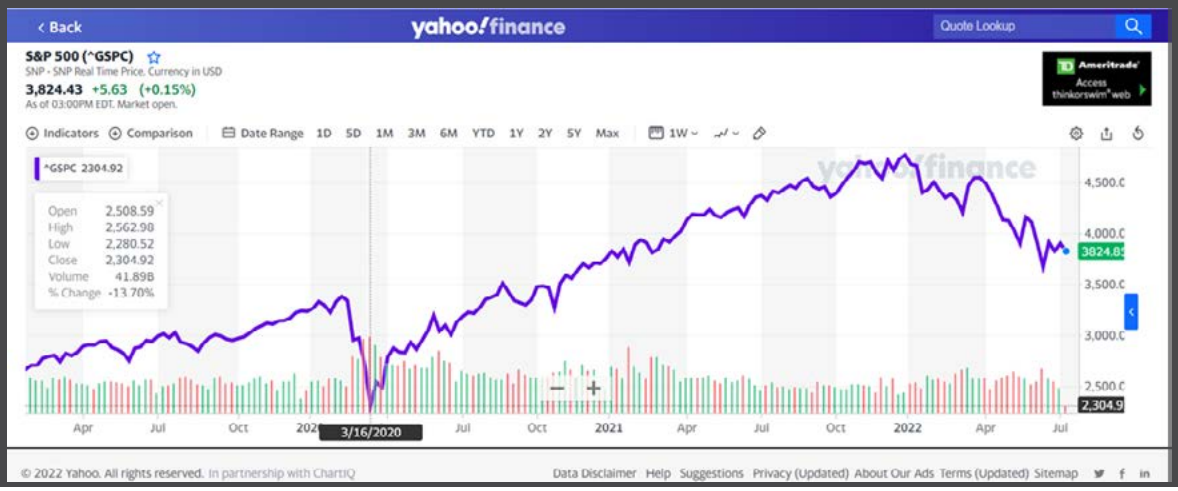
Considerations in Voidable Transfer Actions

- Assessment of prior projections by management and/or financial advisors
  - Valuations used for debt financing
  - Valuations used for internal purposes
  - Valuations supporting M&A transactions
  - Sales of shares
- Assessment of base-case projections and alternatives used in prior solvency opinions and fairness opinions

Considerations in Voidable Transfer Actions: Impact of Recent Economic Events

- Timing of valuation, solvency opinion and/or fairness opinion
- What was known or knowable?
- Timeline of events
  - Pre-pandemic indicators
  - March 2020 stock market collapse
  - Lock downs: Local & state-specific/regional/national/international
  - Lock downs: Industry-specific impact (Healthcare vs. Restaurant/Travel)
  - 2020 - 2021 stock market recovery: Industry-specific?
  - 2022 stock market collapse and potential recession

Stock Market 4/2019-7/2022 (S&P 500)



Example: Georgia 2020-2022 Governor's COVID-19 Executive Orders

- 3/16/2020: Public Health State of Emergency
- 3/18/2020: Public School Closure
- 4/3/2020: Shelter in Place except "Essential Services"
- 4/23/2020: Social Distancing. Face Masks Encouraged (no mandate)
  - Bars, Performance Venues, Public Pools closed
- 5/28/2020: Businesses open under restrictions (except Performance Venues)
- 7/1/2021: Public Health State of Emergency Lifted
- 6/30/2021-4/15/2022: State of Emergency: Economy, Supply Chain, Healthcare Infrastructure
- 4/14/2022 – **8/13/2022**: State of Emergency: Supply Chain

What we know, or don't know, today…

- Potential for Recession?
- Inflation?
- Interest Rates?
- Impact of continued Supply Chain Disruption?
- Impact of War in Ukraine? (i.e., food, oil & gas, rare earth minerals)
- Impact of Oil & Gas Shortage? (local/national/international)
- Labor Shortages and Mass Layoffs?
- Regulation?

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Background to the Uniform Voidable Transaction Act

On July 16, 2014, the Uniform Law Commission approved a series of amendments to the Uniform Fraudulent Transfer Act and changed the name of the uniform law from the UFTA to the Uniform Voidable Transactions Act.

A driving force behind the name change is the concept of "constructive fraud," which permits the avoidance of transfers made or of obligations incurred by an insolvent debtor in exchange for less than reasonably equivalent value. Although denominated as "fraud," a constructively fraudulent transfer involves neither fraud nor improper intent.

To address these concerns, the word "fraud" has been supplanted by the term "voidable." The UVTA adopts the view that even "actually fraudulent" transfers do not require fraud. In lieu of the traditional standard applied to transfers made with the intent to "hinder, delay or defraud" creditors, the UVTA shifts the inquiry to "hinder or delay" and substitutes the idea of "unacceptably contraven[ing] norms of creditors' rights" as the measure for when efforts to hinder or delay render a transaction voidable.

The UVTA makes other key changes, including the following:

- It explicitly states that the burden of establishing the elements of a claim is by a "preponderance of the evidence," rather than the "clear and convincing evidence" standard applied by some courts.
- It refines the rebuttable presumption that a debtor is insolvent if it fails to pay debts as they mature by: (i) clarifying that any nonpayment of debts subject to "bona fide dispute" is not presumptive of insolvency; and (ii) expressly providing that the burden to rebut this presumption falls on the "party against whom the presumption is directed."
- It carves out "strict foreclosures"—in which a debtor consents to the secured creditor's acceptance of collateral in full or partial satisfaction of the obligation, without a public sale or judicial foreclosure—from the defense that the enforcement of a security interest in accordance with Article 9 of the UCC is protected from an avoidance action. However, the secured creditor may still protect a transfer by demonstrating that the foreclosure sale was conducted in good faith and in a commercially reasonable manner.

- As to potential choice of law disputes, the UVTA provides that the law of the state of the business debtor's place of business or, if business is conducted in more than one state, the state of the business's chief executive office, at the time that a transfer was made, applies to claims under the UVTA.

D&O Insurance Coverage for Fraudulent Transfer Claims

Issue:

Whether D&O insurance policies may cover fraudulent transfer claims?

Discussion:

The conventional wisdom among bankruptcy professionals is that fraudulent transfers are uninsurable. There is some support for the conventional wisdom. *See, e.g., Stanley v. U.S. Bank Nat'l Assoc.* (*In re TransTexas Gas Corp*.), 597 F.3d 298, 310 (5th Cir. 2010) (holding that the "return of funds due to a fraudulent transfer is in the nature of restitution" and uninsurable as a matter of law).

But courts have started to rule otherwise. *See, e.g., Greater Cmty. Bancshares, Inc. v. Federal Ins. Co.,* No. 4:14-CV-0266-HLM, 2015 WL 10714012, *9 (N.D. Ga. Feb. 9, 2015) (fraudulent transfer claims not necessarily uninsurable under Georgia law); *Federal Ins. Co. v. Continental Cas. Co.*, No. 2:05-cv-305, 2006 WL 3386625, *24 (W.D. Pa. Nov. 22, 2006) (fraudulent transfer and preference claims not uninsurable as a matter of law under Pennsylvania law).

This is particularly so in connection with settlements. *See, e.g., Burks v. XL Specialty Ins. Co.*, 534 S.W.3d 458, 467–70 (Tex. Ct. App. 2015) *vacated but not withdrawn*, 534 S.W.3d 470 (Tex. Ct. App. Jan. 2016) (vacated based on settlement but clarifying that earlier decision "is **not** withdrawn") (emphasis in original); *see also U.S. Bank Nat'l Ass'n v. Indian Harbor Ins. Co.*, 68 F. Supp. 3d 1044, 1053 (D. Minn. 2014) (coverage exists for policy containing a final adjudication provision for payment of alleged settlement restitution reasoning that "parties may contract to require that the payment is actually—and not just allegedly—restitution"); *but see Philadelphia Indem. Ins. Co. v. Sabal Ins. Grp., Inc.*, Case No. 16-62168-Civ-Cooke/Torres, 2017 WL 4310700, **4–6 (S.D. Fla. Sept. 28, 2017) (rejecting the reasoning of *U.S. Bank*).

Courts ruling that fraudulent transfer claims are uninsurable reason that such actions seek restitution. The most prominent restitution-is-uninsurable decision is *Bank of the West v. The Superior Court of Contra Costa Cty.*, 833 P.2d 545 (Ca.

1992). In that decision, the California Supreme Court stated in *dicta*[1] that the complaint in the underlying litigation "did not seek 'damages' for 'unfair competition' within the meaning of the CGL policy." *Id.* at 558. *Bank of the West* is cited, however, for its reasoning: to deter perceived moral hazard, restitution is uninsurable. *Id*. at 555.

Bank of the West may not, however, be persuasive. As an initial matter, it may not be appropriate for courts to consider moral hazard when ruling on insurance coverage issues. *William Beaumont Hosp. v. Federal Ins. Co.*, 552 F. App'x 494, 501 (6th Cir. Jan. 16, 2014) ("Common sense suggests that the prospect of escalating insurance costs and the trauma of litigation to say nothing of the risk of uninsurable punitive damages, would normally neutralize any stimulative tendency the insurance might have.").

Even if *Bank of the West* is persuasive authority, it is unclear that it should apply to avoidance actions. For no-intent fraudulent transfers actions—*e.g.*, insider preferences and constructive fraudulent transfers (or constructive voidable transactions)—there is no risk of moral hazard. *Richardson v. Tessler* (*In the Matter of Checker Motors Corp.*), 495 B.R. 355, 361–63 (Bankr. W.D. Mich. 2013) (preferences and constructive fraudulent transfers are "innocent" claims that do not involve intent).

For actual fraud fraudulent transfer (or actual fraud voidable transactions), a Delaware Superior Court recently ruled that the fraud of a director or officer is insurable under Delaware law. *Arch Ins. Co. v. Murdock*, C.A. No. N16C-01-104-EMD CCLD, 2018 WL 1129110, **11–12 (Del. Super. Ct. Mar. 1, 2018). The court based its reasoning on, among other things, Delaware law authorizing Delaware corporations to purchase D&O insurance for "any liability that could be asserted against" its directors and officers. *Id.* at 12. Given that the Delaware statute, in relevant part, is similar to the statutes of other states, such reasoning may apply in other jurisdictions.

[1] As an alternative basis for its ruling against coverage, the California Supreme Court found that the "claims did not occur in the course of the Bank's advertising activities within the meaning of the CGL policy." *See* 833 P.2d 545, 561.

Crime-Fraud Exception for Fraudulent Transfers

Issue:

Does the crime-fraud exception apply to fraudulent transfers?

Discussion:

Yes, it can. *Discovery-Crime Fraud exception*, FRAUDULENT TRANSFERS, PREBANKRUPTCY PLANNING AND EXEMPTIONS § 18:26 (Aug. 2021 Update) (comprehensively addressing the issue). But the law of the jurisdiction obviously affects the result. In federal court, the U.S. Supreme Court has not given any direction on the "the quantum of proof necessary ultimately to establish the applicability of the crime-fraud exception." *United States v. Zolin*, 491 U.S. 554, 563 & n.7 (1989). As a result, the standards vary from jurisdiction to jurisdiction. For a party seeking discovery based on the crime-fraud exception, however, they should consider seeking an *in-camera* review rather than a wholesale finding of waiver. The reason for doing so is that the burden is considerably lower. *Tindall v. H & S Homes, LLC*, 757 F. Supp. 2d 1339, 1364 (M.D. Ga. 2011) (such standard is "not a stringent one").

Fraudulent Transfers As Crimes

Issue:

Are fraudulent transfers crimes?

Discussion:

It depends on the jurisdiction.

Federal Law

For instance, fraudulent transfers in connection with a bankruptcy case constitute crimes punishable by monetary fine and imprisonment. There are at least two examples.

18 U.S.C. § 152(1) provides the following: "A person who knowingly and fraudulently conceals from a custodian, trustee, marshal, or other officer of the court charged with the control or custody of property, or, in connection with a case under title 11, from creditors or the United States Trustee, any property belonging to the estate of a debtor."

This statute sweeps much more broadly than a fraudulent transfer because it does not require a transfer.

18 U.S.C. § 152(7) provides the following: "A person who in a personal capacity or as an agent or officer of any person or corporation, in contemplation of a case under title 11 by or against the person or any other person or corporation, or with intent to defeat the provisions of title 11, knowingly and fraudulently transfers or conceals any of his property or the property of such other person or corporation."

This statute also sweeps much more broadly than a fraudulent transfer because—like 18 U.S.C. § 152(1)—it also does not require a transfer. But unlike 18 U.S.C. § 152(1), it is not limited to property of the estate.

State Law

Each state obviously is different.

Many states have criminal statutes focused on defrauding judgment creditors. *See*, *e.g.*, Ala. Code § 13A-9-47; Arkansas: A.C.A. § 5-37-211; K.R.S. § 517.070.

Some states have criminal statutes focused on defrauding secured creditors. *See*, *e.g.*, Ala. Code § 13A-9-46.

Related Cause of Action: Unjust Enrichment

Issue:

When can unjust enrichment serve as a substitute or alternative cause of action to a fraudulent transfer?

Discussion:

A number of jurisdictions have recognized that unjust enrichment serves as a substitute, alternative, or additional cause of action to a fraudulent transfer. *See, e.g.*, *Emerald Capital Advisors Corp. v. Bayerische Moteren Werke Aktiengesellschaft (In re Fah Liquidating Corp.)*, 572 B.R. 117, 131 (Bankr. D. Del. 2017); *Nohr v. Jang*, No. 1:14-cv-02761, 2015 WL 13904687, at **2-3 (N.D. Ga. Sept. 17, 2015); Luke A. Barefoot & Mathew J. Livingston, *Unjust Enrichment or Fraudulent Transfer? Try Both*, 16 SEP AM. BANKR. INST. J. 26, at * 26 (Sept. 2017).

Secondary Liability: Aiding and Abetting

Issue:

Do courts recognize a claim for aiding and abetting a fraudulent transfer?

Discussion:

Most courts do not recognize aiding and abetting claims asserted against non-transferees. *Chepstow v. Hunt*, 381 F.3d 1077, 1087-98 (11th Cir. 2004) (refusing to recognize aiding and abetting fraudulent transfer claim against non-transferee.); *Gierum v. Glick* (*In re Glick*), 568 B.R. 634, 677 (N.D. Ill. 2017) (collecting cases regarding same); *Freeman v. First Nat'l Bank*, 865 So. 1272, 1275-1277 (Fla. 2004).

Secondary Liability: Conspiracy

Issue:

Do courts recognize a claim for conspiring to commit a fraudulent transfer?

Discussion:

There is a split of authority regarding whether such a claim may be asserted against a non-transferee. *Conspiracy or aiding and abetting*, FRAUDULENT TRANSFERS, PREBANKRUPTCY PLANNING AND EXEMPTIONS § 3:18 (Aug. 2021 Update) (discussing issue in detail).

On one hand, some jurisdictions like Georgia recognize a claim for conspiring to commit a fraudulent transfer against non-transferees. *Sauer v. Publisher Servs., Inc.*, No. 1:14-cv-698, 2016 WL 1029523, at *8 (N.D. Ga. Mar. 9, 2016) ("Georgia law plainly permits a claim of civil conspiracy to commit a tort, including a fraudulent transfer under the Georgia UFTA.")

On the other hand, other jurisdictions like Florida do not recognize a claim for conspiring to commit a fraudulent transfer against non-transferees. *Landmark Bank v. Community Choice Fin., Inc*., No. 17-60974-CIV, 2017 WL 4310754, at*18 (S.D. Fla. Sept. 28, 2017).

Extraterritoriality of Fraudulent Transfer Claims

Issue:

Do sections 544 and 548 of the Bankruptcy Code apply outside the United States?

Discussion:

There is conflicting authority on point. *Compare e.g., French v. Liebmann* (*In re French*), 440 F.3d 145, 150-152 (4th Cir. 2006) (recognizing that section 548 applies outside of the United States) *with e.g.*, *Sherwood Invs. Overseas Ltd., Inc. v. The Royal Bank of Scottland N.V.* (*In re Sherwood Invs. Overseas Ltd., Inc.*), No. 6:15-cv-1469, 2016 WL 5719450, at **10-12 (S.D. Fla. Sept. 30, 2016) (recognizing that sections 548 and 550 do not apply outside the United States).

Insider Preference Claim

Issue:

Can a plaintiff sue for a preference under the UFTA or the UVTA?

Discussion:

Yes, a plaintiff can sue an insider defendant for a preference. *See e.g.*, O.C.G.A. § 18-2-75(b); F.S. § 726.106(2). Such claims focus on "diminishing the sometimes-unfair advantages insiders possess when they are familiar with the debtor's financial status." *Truelove v. Buckley*, 733 S.E.2d 499, 501–02 (Ga. Ct. App. 2012).

Notes:

Both UFTA and UVTA have a category of voidable transfers to recover preferential transfers, namely, a transfer by an insolvent debtor to a creditor that is an insider of the debtor and that has reasonable cause to believe the debtor to be insolvent.

The insider preference remedy § 5(b) of UVTA provides:

> (b) A transfer made by a debtor is voidable as to a creditor whose claim arose before the transfer was made if the transfer was made to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent.

An insider is defined in much the same way as in the Bankruptcy Code, and includes a relative, a director or officer of a corporate debtor, a general partner, or a person in control of a debtor.

These remedy provisions are available only to an existing creditor.

The premise is that an insolvent debtor is obliged to pay debts to creditors not related to the debtor before paying insiders that have reason to know of the debtor's financial distress.

Advanced Fraudulent Transfers

This is not really a fraudulent transfer remedy at all, but a preferential transfer remedy roughly analogous to that found in the Bankruptcy Code.

Mixed Motives

Issue:

What if a debtor transfers property for a "good" reason or has a mixed motive?

Discussion:

Some jurisdictions only consider transferor's main, dominant, or only purpose. *E.g.*, *Tindall v. H & S Homes, LLC*, 757 F. Supp. 2d 1339, 1364 (M.D. Ga. 2011). However, other courts have adopted the "mixed motive" principle whereby "a plaintiff may carry her burden of showing that a defendant had actual intent to hinder, delay, or defraud without showing that it was the defendant's sole or primary motivation." *Jones v. Mackey Price Thompson & Ostler*, 469 P.3d 879, 889-90 n.9 (Utah 2020) (rejecting standard from *Tindall*).

Notes:

In *Tindall*, the plaintiff sought discovery of relevant attorney-client communications to help establish claims that conveyances of assets were fraudulent attempts to avoid payment of judgments, contending that the communications fell within the crime-fraud exception to the attorney-client privilege and were thus discoverable. An *in camera* review of a memorandum from the attorneys confirmed that a plan was devised by the attorneys to avoid claims of successor liability to the maximum extent possible, including payment of the judgment. The defendants urged that this was not sufficient evidence of fraud, as Georgia law permits a debtor to prefer one unaffiliated third-party creditor over another. The Court disagreed and concluded that Georgia law provides that a debtor can prefer one creditor over another and make transfers to that end *only* if the transfer is made in good faith and does not benefit the debtor, and that the "dominant intent" of the transfer was to hinder, delay, or defraud the plaintiff. *See Bank of Cave Spring v. Gold Kist, Inc.*, 327 S.E. 2d 800 (Ga. Ct. App. 1985) ("Georgia law permits a debtor to prefer one creditor over another and to make assignments to that end, so long as the transfer is made in good faith and does not benefit the debtor.").

In *Jones,* a Utah attorney got into a dispute with his former law firm alleging that he was due a larger share of certain fees recovered by the firm and that the law firm had made voidable transfers by way of oversized distributions to his former

partners so that he could not collect any judgment that he might win against the firm. The firm and his former partners asserted in their defense to the voidable transfer claim that the distributions made by the firm were primarily for tax reasons, and not to thwart any judgment that the attorney might obtain against his former firm.

The trial court ruled that a "mixed motive" for the former partners to make the distributions to themselves existed and that their tax motive prevailed over the motive of stripping of the firm's assets. The Utah Supreme Court rejected this approach holding that actual intent to hinder, delay, or defraud may be established on the grounds that at least one of the defendant's motives was an impermissible one without showing that it was the defendant's sole or primary motivation. Just establishing that a transfer was part of "business planning," "estate planning" or "succession planning" or, as in *Jones*, "tax planning," is not going to save the transaction if creditor problems later develop and there is even the slightest appearance that the planning was meant to defeat the rights of those creditors.

Triggering Creditor Extending the Reach-back Period Under Section 544

Issue:

Can the statutes of limitation under Section 544 be extended by virtue of the identity of the triggering creditor?

Discussion:

Yes, depending on the jurisdiction and finding the correct triggering creditor. For a comprehensive discussion, *see* Michael H. Strub, Jr., & Jeffrey M. Reisner, *The Expansion of the Triggering Creditor Doctrine in an Action to Avoid Fraudulent Transfers*, 24 AM. BANKR. INST. L. REV. 249, 270–77 (Winter 2016).

Notes:

Under 11 U.S.C. § 544(b), a trustee can only avoid a transfer of the debtor's interest in property if the debtor's interest is voidable under state law "by a creditor holding an unsecured claim that is allowable" against the bankruptcy estate. Section 544(b) requires the trustee to step "into the shoes of a qualifying unsecured creditor, that is, one who could avoid the transfer under applicable state law. Absent a qualifying (sometimes called a "triggering") creditor, the plaintiff may not use Section 544(b) to avoid any alleged fraudulent transfers.

When exercising his or her powers under Section 544(b), the trustee utilizes the applicable nonbankruptcy voidable transfer statute and, thereunder, must identify that creditor. The trustee also has the power to void transfers under federal voidable transfer law codified in Section 548 of the Bankruptcy Code. If the trustee uses the avoidance power in Section 548, the trustee need not identify a triggering creditor, because the power to avoid the transfer under federal fraudulent transfer law does not depend on the rights of any particular creditor of the debtor. In fact, the trustee can avoid the transfer even if no actual creditor could have done so prior to the filing of the debtor's bankruptcy. The trustee's avoidance powers under Section 548, however, are constrained by the fact that the transfer must have been "made . . . within 2 years before the date of the filing of the petition." State avoidance statutes typically contain longer limitations periods.

The trustee has the ultimate burden to establish at trial the existence of a triggering creditor. Parties often point to creditor proofs of claim filed in the debtor's

bankruptcy case to serve as the triggering creditor. The court's ability to take judicial notice of such proofs of claim, however, is limited to the fact that they were filed against the estate, and the court cannot judicially notice the truth of the matters asserted in the proofs of claim. Even the contents of a proof of claim do not provide competent evidence of the existence of a triggering creditor against the debtor.

The selection of the proper triggering creditor can be an important tactical decision. Because the trustee stands in the shoes of the triggering creditor, that creditor must actually have the required non-bankruptcy cause of action, and the trustee is bound by any defenses that the transferee could assert against the unsecured creditor.

Trustees have relied on Section 544(b) and the triggering creditor doctrine to try to expand their powers by using the United States government as the triggering creditor because the trustee can obtain the benefits of a longer statute of limitations applicable to claims by the federal government to challenge voidable transfers. For example, many state voidable transfer statutes provide that the trustee must bring a claim within four years after the transfer. The federal government, however, can bring a claim within six years after the right of action accrues, and the Internal Revenue Code provides the even longer period of ten years for collection from a transferee of a creditor of the Internal Revenue Service. If the trustee can stand in the shoes of a governmental creditor, he or she can potentially void transfers that occurred long before the debtor's bankruptcy filing. Courts are split on the issue of whether the trustee can rely on the United States government as the triggering creditor under federal law. Some courts believe that it is inappropriate for the trustee to take advantage of the special rights of the United States government as a sovereign for the benefit of other non-governmental creditors, *e.g.*, *In re Vaughan Co.*, 498 B.R. 297, 304 (Bankr. D.N.M. 2013), while others hold that this is irrelevant because the triggering creditor doctrine empowers the trustee to step into the shoes of any creditor for the benefit of other creditors.

Presumption of Actual Intent Arise Through the Badges of Fraud

Issue:

Can a presumption of fraud arise out of the badges of fraud?

Discussion:

No. The Official Comments to the Uniform Law Commission say it cannot. Official Comment 6 to UVTA § 4; 7A Uniform Laws Annotated, Prefatory Note, Comment 5 to UFTA § 4, p. 303. But courts often rule the other way. *Bamberger Polymers, Inc. v. Cal W. Packaging Corp.*, No. 14-2280, 2015 WL 12867317, *5 (W.D. Tenn. Mar. 17, 2015) ("The presence of one or more badges of fraud gives rise to the presumption of actual intent to defraud.")

Recovery of Pre-judgment Interest under State Law Versus Federal Law

Issue:

Is pre-judgment interest for fraudulent transfer claims asserted under Section 544 calculated under state or federal law?

Discussion:

Courts are divided on the calculation of prejudgment interest in voidable transaction awards as to whether such amount should be determined under state or federal law. *See* Harris Winsberg & Karen Visser, *A Survey on Prejudgment Interest Awards in Preference and Fraudulent Conveyance Avoidance Actions*, 24 Norton J. Bankr. L. & Prac. n.45 (2015) (comparing cases).

Notes:

Post-judgment interest is governed by 28 U.S.C. § 1961(a), which provides: "Interest shall be allowed on any money judgment in a civil action recovered in a district court. . . . Such interest shall be calculated from the date of the entry of the judgment." Section 1961 applies to judgments of the bankruptcy court, as a "unit" of the district court. Because post judgment interest is mandated by federal statute, a prevailing party in a bankruptcy court action is automatically entitled to post judgment interest regardless of whether post judgment interest is referenced in the pleadings, a court's order or monetary judgment. Federal law governs the rate of post judgment interest on a federal court judgment even in an action otherwise governed by state law.

However, neither the Bankruptcy Code nor the United States Code contains a general statute granting prejudgment interest. Prejudgment interest is generally subject to the court's discretion depending on the equities of the case. Prejudgment interest has a compensatory purpose, and a court may award prejudgment interest to make the injured party "whole." In light of these interests, courts have traditionally awarded prejudgment interest to a trustee who successfully avoids a preferential or fraudulent transfer from the time demand is made or an adversary proceeding is instituted. The question becomes what is the applicable rate of prejudgment interest, the federal or state rate?

Federal courts addressing the choice of law question often look to the source of a plaintiff's claim when determining the governing law of prejudgment interest: if federal law gives rise to the claim, federal law governs the rule of prejudgment interest to be applied. Likewise, if state law is the source of the claim, then state law governs the rate of prejudgment interest. Often voidable transaction actions are brought concurrently under federal and state law. Courts have reached different conclusions regarding whether federal or state law governs prejudgment interest in voidable transfer actions. Many courts have applied the state law interest rate for determining prejudgment interest on voidable transfer judgments arising under § 544(b). *See e.g., In re Keefe*, 401 B.R. 520 (B.A.P. 1st Cir. 2009).

The court in *In re Keefe* reasoned that Section 544(b) was simply the provision that allowed the trustee to assert the voidable transfer claim, and Section 550 simply identifies the entities from whom recovery could be made. Therefore, neither Section 544(b) nor Section 550 is the substantive basis for the judgment; rather, the substantive basis was the state voidable transfer statute. Since state law was the substantive law for the voidable transfer judgment, the bankruptcy court should have looked to state law to determine the applicable rate of prejudgment interest.

Other courts, however, have awarded prejudgment interest at the federal rate, reasoning that strong-arm proceedings are brought pursuant to Sections 544 and 550 of the Bankruptcy Code, a federal statute. *See e.g., Kelley as Trustee for PCI Liquidating Trust v. Boosalis*, 974 F.3d 884 (8th Cir. 2020).

The Eighth Circuit reasoned that the authority to recover money judgments against defendants, rather than only recovery of property, is conferred by Section 550, which lists seven avoidance provisions in the Bankruptcy Code, including Section 544. Because Section 544(b)(1) says nothing about recovery, the recovery of voidable transfers is authorized is authorized by federal law— Section 550(a)(1). Therefore, Section 550 provides the basis for recovery *once* the transfer has been avoided through one of the provisions listed in Section 550(a). The state voidable transfer law provided the substantive basis for defendant's voidable transfer liability but not the right to a recovery to which the trustee was therefore entitled. As the source of recovery, Section 550 was the source for the award of prejudgment interest. Since it was undisputed that jurisdiction is based on a federal question that was presented, not diversity or supplemental jurisdiction, the proceedings to avoid voidable transfers under Section 544 are "core proceedings arising under title 11" that may be delegated to a bankruptcy court for final disposition. 28 U.S.C. § 157(b)(1), (b)(2)(H). Section 544(b)(1) permits a trustee to pursue a federal cause of action in bankruptcy court. The cause arises under federal law because it creates

the cause of action asserted. A federal cause of action therefore requires application of federal law to an award of prejudgment interest.

Paths to Reasonably Value When the Debtor Does Directly Received the Corresponding Transfer: "Indirect Benefit," "Identity of Interests," and "Common Enterprise"

Issue:

What are the "indirect benefit," "identity of interests," and "common enterprise" doctrines?

Discussion:

"Indirect benefit." Targets of voidable transfer claims often assert, in defense, that the debtor received reasonably equivalent value through "indirect benefits" shared between the debtor and other businesses or entities that actually did receive consideration related to the voidable transfer. In cases when the debtor making an allegedly fraudulent transfer is closely related to the party benefiting from the transfer, courts have often found reasonably equivalent value based simply on the benefit to the latter party. *Nordberg v. Societe Generale (In re Chase & Sanborn Corp.)*, 848 F.2d 1196, 1198 n.7 (11th Cir. 1988). These courts reason that ***that*** benefit confers an indirect but equally real benefit to the debtor.

"Identity of interests." The identity of interests rule recognizes that if the debtor and the third party are so related or situated that they share an identity of interests, then what benefits one will, in such case, benefit the other to some degree. The identity of interests rule is simply one way of showing a debtor received reasonably equivalent value in the form of an indirect benefit—thereby eliminating an essential element of constructive fraud.

"Common enterprise." The common enterprise or single business enterprise doctrines provide that the legal fiction of a distinct corporate entity may be disregarded when a corporation is so organized and controlled as to make it merely an instrumentality or adjunct of another corporation. Although recognized in other jurisdictions, the common enterprise doctrine has not been recognized by the Eleventh Circuit. The bankruptcy court in *In re TOUSA, Inc.*, 422 B.R. 783, 861 (Bankr. S.D. Fla. 2009), *quashed in part*, 444 B.R. 613 (S.D. Fla. 2011), *aff'd in part*, *rev'd in part*, 680 F.3d 1298 (11th Cir. 2012), expressly rejected the application of the common enterprise doctrine as a defense to a voidable transfer claim unless the prerequisites for applying the doctrines of substantive consolidation and veil piercing were present.

Notes:

Courts have analyzed the "identity of interests" doctrine and the "common enterprise" doctrine as two separate doctrines. *See Herendeen v. Regions Bank (In re Able Body Temp. Servs., Inc.)*,587 B.R. 392, 405 (Bankr. M.D. Fla. 2018), *on reconsideration in part sub nom. In re Able Body Temp. Servs., Inc.*, No. 8:13-BK-06864-CED, 2018 WL 11206122 (Bankr. M.D. Fla. Sept. 4, 2018); *Herendeen v. Regions Bank (In re Able Body Temp. Servs., Inc.)*, 626 B.R. 643 (Bankr. M.D. Fla. 2020).

The "common enterprise" doctrine invokes the equitable doctrines of substantive consolidation and alter ego, and a proponent must prove the required element of a "substantial identity between the entities to be consolidated." *Eastgroup Props. v. Southern Motel Assoc., Ltd*., 935 F. 2d 245 (11th Cir. 1991). The common enterprise doctrine is predicated on the notion that the legal fiction of separate corporate entities should be disregarded where the entities are organized and controlled as a single operation. But, the "identity of interests" doctrine focuses on the *economic realities* of the entities, not their corporate separateness.

The identity of interests rule recognizes that if the debtor and the third party are so related or situated that they share an identity of interests, then *what benefits one will, in such case, benefit the other to some degree*. The identity of interests doctrine recognizes that the facts may suggest that a corporate group has purposely availed itself of the benefits of an enterprise and should be treated as one borrowing unit *even though each member of the enterprise is a separate entity*.

In other words, a corporate group may have an identity of economic interests without finding that the separate corporations are controlled as a single entity.

Using Recharacterization To Challenge Antecedent Debt

Issue:

Can recharacterization be used to challenge the antecedent debt that a defendant would use as its reasonably equivalent value?

Discussion:

The ability of a bankruptcy court to reorder the priority of claims or interests by means of equitable subordination or recharacterization of debt as equity is generally recognized. Even so, the Bankruptcy Code itself expressly authorizes only the former of these two remedies. Although common law uniformly acknowledges the power of a court to recast a claim asserted by a creditor as an equity interest in an appropriate case, the Bankruptcy Code is silent as to the availability of the remedy in a bankruptcy case.

This has led to uncertainty in some courts concerning the extent of their power to recharacterize claims and the circumstances warranting recharacterization. The Ninth Circuit Court of Appeals considered this issue *in In Official Committee of Unsecured Creditors v. Hancock Park Capital II, L.P. (In re Fitness Holdings International, Inc.)*, 714 F.3d 1141 (9th Cir. 2013). The court ruled that "a court has the authority to determine whether a transaction creates a debt or an equity interest for purposes of § 548, and that a transaction creates a debt if it creates a 'right to payment' under state law."

In a case alleging a "scheme and device" to make loans to a debtor rather than properly capitalize the debtor, the Eleventh Circuit has identified two threshold, prerequisite conditions that allow a recharacterization claim to be pleaded at all: "[s]hareholder loans may be deemed capital contributions in one of two circumstances: where the trustee proves initial under-capitalization or where the trustee proves that the loans were made when no other disinterested lender would have extended credit." *Estes V. N & D Props., Inc., (In Re N&D Props., Inc.)*, 799 F.2d 726, 733 (11th Cir. 1986) (discussing an element of the "Deep Rock" doctrine for subordinating claims stemming from *Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307 (1939)).

Notes:

To support the extreme relief of recharacterizing debt to equity, courts in the Eleventh Circuit look to thirteen independent factors. *See e.g., Stinnett's Pontiac Serv., Inc., v. Comm'r of IRS*, 730 F.2d 634, 638 (11th Cir. 1984) (noting that all of the factors should be considered, while realizing that the various factors are not of equal significance and that no single factor is controlling); *In re Blevins Concession Supply Co*., 213 B.R. 185, 186–87 (Bankr. M.D. Fla. 1997); *Celotex Corp. v. Hillsborough Holdings Corp. (In re Hillsborough Holdings Corp.),* 176 B.R. 223, 248 (Bankr. M.D. Fla. 1994) (analyzing thirteen-factor test to determine the actual manner, not the form, in which the parties intended to structure the advance at issue); *In re Biscayne Inv. Group*, 264 B.R. 765 (Bankr. S.D. Fla. 2001) (considering thirteen factors).

These factors include: (1) names given to the certificates evidencing the indebtedness; (2) presence or absence of a fixed maturity date; (3) source of payments; (4) right to enforce payment of principal and interest; (5) participation in management flowing as a result of the advances; (6) status of the contribution in relation to regular corporate creditors; (7) intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) ability of the corporation to obtain loans from outside lending institutions; (12) extent to which the advance was used to acquire capital assets; and (13) failure of the debtor to repay on the due date or to seek a postponement.

Merit Management and Its Progeny

Issue:

Merit Management and its progeny: how safe are safe harbors anyway?

Discussion:

Section 546 of the Bankruptcy Code imposes limitations on a bankruptcy trustee's avoidance powers and created a safe harbor exempting from constructive avoidance certain securities transaction payments. The purpose of this safe harbor provision found in Section 546(e) is to prevent the bankruptcy of one securities market participant from affecting the securities market as a whole. This safe harbor is an important defense against voidable transfer claims seeking to unwind transactions prior to a bankruptcy that involve the debtor taking on new debt.

In 2018, a unanimous Supreme Court in *Merit Management Group, LP v. FTI Consulting, Inc.*, 138 S. Ct. 883 (2018) rejected decisions that had previously expanded the safe harbor in § 546(e) to protect transfers from being avoided as constructively voidable if the funds at issue passed through a financial institution or another covered entity acting as a conduit, even if neither the transferor nor the transferee was itself a covered entity. The Supreme Court determined that the safe harbor protects a transaction *only* if the transferor or the transferee of the "relevant transfer" (*i.e.*, the "overarching" transfer sought to be avoided) was itself a covered entity. Thus, *Merit Management* narrowed the scope of the safe harbor by making clear that the relevant inquiry is whether the transferor or the transferee in the transaction whose avoidance is sought is itself a financial institution. The Supreme Court declined to address whether and under what circumstances Section 546(e) protects a customer of a financial institution.

Notes:

Courts are again divided on the scope of the Section 546(e) safe harbor and whether the constructive avoidance transfer is preempted because it involves a financial institution by virtue of a party being a customer of a financial institution and the financial institution acted as an agent or custodian in connection with the transaction or whether the financial institution was a mere intermediary to effectuate the transaction. The Second Circuit held in *In re Tribune Co. Fraudulent Conveyance Litigation*, 946 F.3d 66 (2d Cir. 2019) that the safe-harbor provision in

Section 546(e) barred claims seeking to claw back payments that Tribune Co. made to public shareholders in 2007 as part of a go-private transaction. The Second Circuit held that Tribune constituted a "financial institution," which includes a "customer" of a financial institution when the financial institution acts as the customer's "agent or custodian ... in connection with a securities contract. *Tribune* signals that, at least in the Second Circuit, the safe harbor might still protect securities transactions where a financial institution acts as agent or custodian for the transferor or transferee as its customer.

Another court has disagreed at length with the Second Circuit. *In re Greektown Holdings, LLC*, 621 B.R. 797, 825-34 (Bankr. E.D. Mich. 2020). The *Greektown* court was "not persuaded" by the Second Circuit's "financial institution" holding because that holding did "not distinguish between mere intermediaries contracted for the purpose of effectuating a transaction and agents who are authorized to act on behalf of their customers."

Rights of Unliquidated Claimants under UVTA and UFTA

Issue:

Whether a tort claimant—which has not reduced its claim to a judgment—is entitled to the protections of the Uniform Acts?

Discussion:

Yes. UFTA confers remedies on "creditors." *See*, *e.g.*, .C.A. §§ 66-3-305 (entitled "Transfers fraudulent as to present and future creditors"), 66-3-306 (entitled "Transfers fraudulent as to present creditors"), 66-3-308 (entitled "Remedies of creditors"). So, the issue is whether a tort claimant—which has not reduced its claim to a judgment—is a "creditor."

"'Creditor' means a person with a claim." *See*, *e.g.*, T.C.A. § 66-3-302(4). And a "claim" in relevant part "means a right to payment, *whether or not the right is reduced to a judgment*, liquidated, *unliquidated*, fixed, *contingent*, matured, unmatured, *disputed*, undisputed, legal, equitable, secured, or unsecured." *See*, *e.g.*, T.C.A. § 66-3-302(3) (emphasis added).

The comment on the definition of "creditor" states that the "holder of an *unliquidated tort claim* or a *contingent* claim may be a creditor protected by this Act." *See*, *e.g.*, T.C.A. § 66-3-302, cmt. 4 (emphasis added); *see also* T. C. A. § 66-3-308, cmt. 4 ("As under the Uniform Fraudulent Conveyance Act, a creditor is not required to obtain a judgment against the debtor transferor or to have a *matured* claim in order to proceed" with remedies.) (emphasis added).

Courts around the country have also so ruled. *See*, *e.g.*, *Burkhart v. Genworth Fin., Inc.*, C.A. No. 2018-0691-JRS, 2020 WL 507938, *8 (Del. Ch. Jan. 31, 2020) ("Creditors are not 'required to stand by helplessly until a distant maturity date arrives while his debtor is fraudulently depleted of all assets."); *Riegel v. Jungerman*, WD 82279, 2019 WL 7157248, *9 (Miss. Ct. App. Dec. 24, 2019) (unpublished) ("[T]he statute plainly defines individuals as 'creditors' even if their claims against a debtor have not been reduced to a judgment, and even if those claims are unliquidated, contingent, and disputed. The fact that Riegel's wrongful death claim has not been litigated to final judgment does not prevent her from being a 'creditor' possessing a "claim" within the meaning of the Fraudulent Transfer Act."); *Bell v. Goforth*, No. M2004-00997-COA-R3-CV, 2006 WL 627189, n.5 (Tenn. Ct. App. Mar. 14, 2006) ("In fact, Ms. Bell would have qualified as a creditor

even if she had not yet obtained a judgment against the two corporations. The plaintiff in a tort action is a 'creditor' for the purpose of a fraudulent transfer claim.")

Venue in Federal District Court for UVTA and UFTA Claims

Issue:

Does venue exist for UVTA and UFTA claims in federal district court in the same district where venue exists for the creditor's underlying claim?

Discussion

Yes. In *SE Property Holdings, LLC v. Center*, No. 15-0033-WS-C, 2015 WL 4478154 (S.D. Ala. July 21, 2015), the court ruled that venue in a fraudulent transfer case was proper in the Southern District of Alabama. The court concludes that the "point is straightforward: [t]he right to payment which forms the backbone of SEPH's fraudulent transfer claims came into being in this judicial district." 2015 WL 4478154, *1. The court reasons as follows:

> The applicable statute (the so-called "transactional venue" provision) states that "[a] civil action may be brought in ... a judicial district in which a substantial part of the events or omissions giving rise to the claim occurred, or a substantial part of property that is the subject of the action is situated." 28 U.S.C. § 1391(b)(2). The law is clear that "under § 1391 a plaintiff does not have to select the venue with the *most* substantial nexus to the dispute, as long as she chooses venue where a substantial part of the events giving rise to the claim occurred." *Morgan v. North MS Medical Center, Inc.,* 403 F.Supp.2d 1115, 1122 (S.D.Ala.2005) (citations omitted). Nor is the term "substantial part," as used in § 1391(b)(2), properly construed as a synonym for "majority." *See, e.g., Anthony Sterling, M.D. v. Provident Life and Acc. Ins. Co.,* 519 F.Supp.2d 1195, 1206 (M.D.Fla.2007)("*Jenkins* does not limit the term substantial part to mean the majority of the acts."). 3 It is true that "[o]nly the events that directly give rise to a claim are relevant." *Jenkins Brick Co. v. Bremer,* 321 F.3d 1366, 1371 (11th Cir.2003). It is also true, however, that courts "should review the entire sequence of events underlying the claim." *Mitrano v. Hawes,* 377 F.3d 402, 405 (4th Cir.2004) (citations and internal

> quotation marks omitted); *see also Astro–Med, Inc. v. Nihon Kohden America, Inc.,* 591 F.3d 1, 12 (1st Cir.2009) (similar); *Cox v. Sullivan,* 2014 WL 4352088, *3 (N.D. Okla. Sept. 2, 2014) (for purposes of § 1391(b)(2), "courts are instructed to focus on the entire sequence of events giving rise to the claim, rather than merely where the 'triggering event' occurred").

2015 WL 4478154, *1. The court determines that to assert a cause of action under UFTA a plaintiff must be a "creditor." And to be a creditor, the plaintiff must have a "claim."

As a result, the court concludes that the "point is straightforward: [t]he right to payment which forms the backbone of SEPH's fraudulent transfer claims came into being in this judicial district." 2015 WL 4478154, *1. In other words, under *SE Property,* venue in a district is proper for a fraudulent transfer claim if the underlying claim—which makes the fraudulent transfer plaintiff a "creditor" for purpose of UFTA—"came into being" in such judicial district.

Debtor could move for a transfer of venue to the Southern District of Georgia under 28 U.S.C. § 1404(a). But a "prominent factor in such analysis is plaintiff's choice of forum." *SE Prop.*, 2015 WL 4478154, *4.

Injunctive Relief for Claims Under UVTA and UFTA

Issue:

Is an injunction a potentially available remedy for a creditor?

Discussion:

Yes. Numerous courts have granted injunctive relief under UFTA. *See*, *e.g.*, *McGirr v. Reheme*, 891 F.3d 603, 610-15 (6th Cir. 2018) (entering injunction against an attorney from making asset transfers under the Ohio Uniform Fraudulent Transfer Act); *Janvey v. Alguire*, 647 F.3d 585, 602-03 (5th Cir. 2011) (granting the SEC an injunction under Texas Uniform Transfer Act); *Mitsubishi Power Sys. Ams., Inc. v. Babcock & Brown Infrastructure Grp. U.S., LLC*, C.A., No. 4499-VCL, 2009 WL 1199588, at *6 (Del. Ch. Apr. 24, 2009) (granting temporary restraining order against prospective fraudulent transfer other than sales in the ordinary course of business and sales for which the proceeds are escrowed); *Bowman v. Dixon Theatre Renovation, Inc.*, 581 N.E.2d 804, 809 (Ill. App. Ct. 1991) (upholding preliminary injunction against prospective fraudulent transfer).

And it is unlikely that a defendant can avoid such an injunction based on *Grupo Mexicano de Desarrollo S.A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308 (1999). *EHT US1, Inc. v. EHT Asset Mgmt., LLC*, No. 21-10036, 2021 WL 3828556, *1 (Bankr. D. Del. Aug. 27, 2021) (concluding that *Grupo* does not apply to fraudulent transfer cases).

UVTA and UFTA Violations Associated with the Transfer of a Fully Encumbered Asset?

Issue:

Can a creditor assert a claim under UVTA or UFTA associated with the transfer of the debtor's asset where an under-secured lender has a properly perfected security interest in such asset? No.

Can a creditor assert a claim under UVTA or UFTA associated with the transfer of the debtor's asset where an over-secured lender has a properly perfected security interest in such asset? Yes.

Can a creditor assert a claim under UVTA or UFTA associated with the transfer of the debtor's asset where an under-secured lender has an unperfected security interest in such asset? Yes.

Can a creditor assert a claim under UVTA or UFTA associated with the transfer of the debtor's asset where an over-secured lender has an unperfected security interest in such asset? Yes.

Discussion:

A creditor cannot assert a claim under UVTA or UFTA associated with the transfer of the debtor's intellectual property if the lender's claim is greater than the value of the intellectual property and the lender's security interest is properly perfected. A creditor could assert such claim if the security interest were not perfected. The same is true even if the security interest were perfected as long as the intellectual property's value is greater than the amount of the lender's claim.

Under UFTA and UVTA, to have any type of fraudulent transfer claim—based on a transfer of an asset, there must be a "transfer" as that term is defined in TENN. CODE ANN. § 66-3-302(12). TENN. CODE ANN. § 66-3-305(a); TENN. CODE ANN. § 66-3-306. A "transfer" must involve an "asset or an interest in an asset." TENN. CODE ANN. § 66-3-302(12). But an "asset" does not include "property *to the extent* it is encumbered by a *valid lien*." TENN. CODE ANN. § 66-3-302(2) (emphasis added).

To interpret the exception, there are two phrases that must be tackled: "to the extent that" and "valid lien."

"To the Extent that"

Courts have interpreted the phrase "to the extent that" to mean that the exception only applies to the extent an asset is fully encumbered. In other words, to the extent that the asset is only partially encumbered, the equity in the asset (*i.e.*, the amount that the value of the asset exceeds the amount of the liens) is an "asset." *Webster Indus., Inc. v. Northwood Doors, Inc.*, 320 F. Supp. 2d 821, 837 (N.D. Iowa 2004) (collecting authorities from various jurisdictions).

"Valid Lien"

For an Article 9 security interest to be a "valid lien," it must be perfected. *Permasteelisa CS Corp. v. The Airolite Co.*, No. 2:06-CV-569, 2007 WL 4615779, *6 (S.D. Ohio Dec. 31, 2007).

RECENT CASELAW IN ADVANCED FRAUDULENT TRANSFERS

Philadelphia Entertainment and Development Partners LP v. Department of Revenue, 860 Fed.Appx. 25 (3rd Cir. 2021).

The Third Circuit affirmed bankruptcy and district court rulings dismissing debtor's adversary proceedings against Pennsylvania for fraudulent transfers, seeking to recover the value of a slot machine license the state had revoked. To be recoverable under sections 548 or 544, Plaintiff had to first establish a property interest in the license existed, and then establish it was an asset of the debtor recoverable under section 544. The court ruled that under Pennsylvania law, the gambling license was a privilege, not a property right, and affirmed the lower court dismissals.

Cook v. U.S. (In re Yahweh Center, Inc.), 27 F.4th 960 (4th Cir. 2022).

The Fourth Circuit affirmed bankruptcy and district court rulings that IRS imposition of and collection of a debtor's prepetition payments on the paid tax penalty imposed for chronic unremitted employee withholding taxes is not a fraudulent transfer under section 544 of the Bankruptcy Code, employing the North Carolina version of the Uniform Voidable Transactions Act. Ordinarily, a payment is a transfer of property, and if made within the statutory time period while the debtor is insolvent for less than reasonably equivalent value, is avoidable as a constructively fraudulent transfer. However, tax penalties are not "obligations" incurred as contemplated by the fraudulent transfer statutes, which presume a voluntary exchange between debtor and creditor. Three is no transfer here for the underlying obligation. The IRS is not a voluntary creditor because "tax penalties arise not through contractual bargaining but by operation of statute, and no value is or can be given in exchange." Therefore, payment of a duly imposed tax penalty is not a "transfer" as defined or contemplated under section 548 or UFTA/UVTA state law (section 544) because the of the involuntary nature of the tax penalties. As a side-note, the IRS asserted a blanket sovereign immunity defense to section 544 actions because of its invocation of state law. The circuit court ruled that sovereign immunity is waived as to section 544 actions by section 106(a) of the Bankruptcy Code *and* the proof of claim filed by the IRS in the case.

In re Venoco LLC, 998 F.3d 94 (3d Cir. 2021), cert. denied sub nom. California State Lands Comm'n v. Davis, 142 S. Ct. 231 (2021)

The debtor operated drilling rigs off the California coast and a refinery sitting on the coast of the mainland. Upon a second bankruptcy petition filing, California seized the debtor's refinery without compensation, asserting the police power exception and need to protect the environment plus public safety. The trustee filed an adversary proceeding to recover the value for fraudulent transfer and inverse condemnation. California asserted sovereign immunity.

Interpreting *Central Virginia Community College v. Katz*, 546 U.S. 356, 378, 126 S.Ct. 990, 163 L.Ed.2d 945 (2006), which held that in ratifying U.S. Constitution, states submitted to the Bankruptcy Clause and waived sovereign immunity for "a bankruptcy court's exercise of its

jurisdiction over property of the debtor and its estate (called "*in rem* jurisdiction")", the two lower court rejected the sovereign immunity defense. *Venoco* at 99. However, the waiver is not all-encompassing and sovereign immunity remains if the issue is not sufficiently in rem bankruptcy. The focus is on function, not form. "States cannot assert a defense of sovereign immunity in proceedings that further a bankruptcy court's *in rem* jurisdiction no matter the technical classification of that proceeding."

The key questions are:

- Does it affect interests in the res, the property of the debtor and its estate?
- Even if connection to a specific piece of property is lacking, is there a broader effect on the equitable distribution of the debtor's property?
- Is a state bound by a bankruptcy proceeding if it choose elects not to participate?

The trustee's suit is not clearly *in rem* because it seeks to recover money damages, but its function is to decide rights in a debtor's property. If California could assert sovereign immunity when a monetary claim is made, states would be enables a debtor property freely and without compensation. The court opined:

> "We only hold that, in this case, the Bankruptcy Court's *in rem* jurisdiction extends to the estate's property transferred . . . for the purpose of liquidation and distribution to Venoco's creditors, and over which the Bankruptcy Court retained substantial control under the Plan. And, contrary to the California Parties' parade of horribles, our conclusion does not mean sovereign immunity is waived in every bankruptcy proceeding brought by a post-confirmation trustee. A court must still undertake the proper analysis under *Katz*, and it must also have statutory jurisdiction over the proceeding under *Resorts International*."

Id. at 108-109.

Doubling down, California asserted Eleventh Amendment immunity, arguing that it had not consented to suit in federal court. The circuit court held that *Katz* reaches an assertion of Eleventh Amendment immunity as well. Finally, on appeal for the first time California asserted state law substantive immunity, arguing substantive immunity is jurisdictional and can be raised at any time. The circuit court ruled that a defense rooted in state law cannot define federal court jurisdiction. Allowing a new substantive immunity defense at this late stage would undermine the decision in *Katz* and allow state legislation an ability to end-run the deemed waiver of state sovereign immunity in the Bankruptcy Clause.

***Kelley as Trustee for PCI Liquidating Trust v. Boosalis*, 974 F.3d 884 (8th Cir. 2020).**

PCI supposedly ran a "diverting business" that bought electronics in bulk for resell to major retailers. Actually, it was a front for a $3.5 billion Ponzi Scheme operated by Thomas Petters from 1994 through 2008. (Petters got a 50-year sentence.) PCI filed chapter 11 and a liquidating trustee was appointed. He filed more than 200 avoidance actions seeking to recover PCI's interest

payments to early lenders for the benefit of later lenders who lost out on the Ponzi scheme. The defendants here are Boosalis, Papadimos, and Kanios.

The trustee brought actions under 544(b)(1) and the Minnesota Uniform Fraudulent Transfers Act (MUFTA), seeking to claw back Ponzi interest paid. Defendants Papadimos and Kanios (who are married) received interest payments exceeding $3.7 million, and Boosalis received $3.5 million in interest. The applicable interest rates ranged from 12% and 48%. The jury found all were fraudulent transfers under MUFTA. The court awarded prejudgment interest thereon at state rate of 10% per annum rate from commencement of the action (September 23, 2010) rather than the much lower federal rate. The district court awarded actual damages and prejudgment interest of over $6.8 million. The defendants appealed on several grounds. Of relevance here is whether the § 544(b)(1) avoidance action is a state or federal cause of action for the purpose of calculating prejudgment interest.

Prejudgment interest is a question of federal law where the cause of action arises from a federal statute and is a substantive one controlled by state law, such as in a diversity case. Authority to recover money judgments against defendants, rather than only recovery of property, is conferred by § 550, which lists seven avoidance provisions in the Bankruptcy Code, including 544. "Because § 544(b)(1) says nothing about recovery, the recovery of fraudulent transfers is authorized….[the recovery of fraudulent transfers is authorized by federal law—550(a)(1). In re DBSI, Inc. 869 F.3d 1004,1015 (9th Cir. 2017).

Therefore, section 550 provides the basis for recovery *once* the transfer has been avoided through one of the provisions listed in 550(a). "MUFTA provided the substantive basis for defendants fraudulent transfer liability but not the right to a recovery to which the trustee was therefore entitled. As the source of recovery, §550 was the source for the award of prejudgment interest…" (cite page). Here, it is undisputed that jurisdiction is based on a federal question is presented, not diversity or supplemental jurisdiction. Proceedings to avoid fraudulent conveyances under section 544 are "core proceedings arising under title 11" that may be delegated to a bankruptcy court for final disposition. 28 U.S.C. § 157(b)(1), (b)(2)(H). Section 544(b)(1) "permits a trustee to pursue a federal cause of action in bankruptcy court." The cause arises under federal law because it creates the cause of action asserted. A federal cause of action requires application of federal law to an award of prejudgment interest. *See* Harris Winsberg and Karen Visser, A Survey on Prejudgment Interest Awards in Preference and Fraudulent Conveyance Avoidance Actions, 24 Norton J. Bankr. L. & Prac. n.45 (2015) (comparing cases).

In re Bernard L. Madoff Investment Securities, LLC, 976 F.3d 184 (2nd Cir. 2020); cert. denied sub nom. Gettinger v. Picard, 141 S. Ct. 2603 (2021).

In a more infamous Ponzi Scheme case, Madoff sent customers fabricated and fictitious statements showing false trading activity and returns not actually generated. When customers withdrew funds, he sent proceeds from other customers. The scheme collapsed in December 2008. BLMIS (Madoff's firm) had insufficient funds to satisfy customer net equity claims. The trustee sought to recover various funds paid to customers under § 548(a)(1)(A) and (B). Some customers had net equity claims, meaning at the time of collapse they had not withdrawn all principal, while other customers had withdrawn principal plus fictitious profits. The district court dismissed the

constructive fraud claims because of the § 546(e) exception, but it allowed the actual fraud claims to proceed since those transfers were not "for value" under § 548(c). The court rejected arguments that § 548(a)(1) prohibited the trustee from considering transfers made more than two years prior to the filing of the petition when calculating the amount subject to recovery. The exposure of each defendant was determined as: "First, amounts transferred by [BLMIS] to a given defendant at any time are netted against the amounts invested by that defendant in [BLMIS] at any time. Second, if the amount transferred to the defendant exceeds the amount invested, the Trustee may recover these net profits from that defendant to the extent that such monies were transferred to that defendant in the two years prior to [BLMIS] filing for bankruptcy. Any net profits in excess of the amount transferred during the two-year period are protected from recovery by the Bankruptcy code's statute of limitations. See 11 U.S.C. § 548(a)(1)."

"For Value" Defense – The defendants first posited two merit arguments that the transfers were made for good value: first, the transfers satisfied a property right to payment of "profits" created by BLMIS account statements; second, the transfers discharged BLMIS liability on claims based on contract rights.

Property rights – The court distinguished prior decisions holding BLMIS account statements created a "settlement payment" within the safe harbor of 546(e). Merely saying these could be settlement payments is different than establishing enforceable legal rights in fictitious profits. Because no profits exists, the defendants had no property rights exceeding principal. Therefore, fictious profits masquerading as interest transfers were not made for value.

Contract rights – Defendants next argue the Securities Exchange Act of 1934 allows an innocent party in a securities contract procured by fraud the choice of voiding or enforcing the contract. Since the defendants are innocent parties, they can enforce the rights to the profits. The court ruled a trustee can invoke fraudulent transfer provision to recover customer property, but whether a transferee can invoke the "for value defense" depends on whether the defense would operate in a manner consistent with Securities Investor Protection Act (SIPA) and its priority system. Here, the "for value defense" conflicts with SIPA. The transfers at issue are not those for a return of principal or net equity, but instead "were transfers of fictitious property in excess of principal that depleted the resources of the customer property fund without an offsetting satisfaction of a debt or liability of that fund." Consequently, the transfers were not "for value" for purposes of 548(c) as that provision applies to SIPA liquidation.

Time-Barred Defense – The defendants asserted a third defense that fraudulent transfer claims subject to avoidance start with and are limited to those that occurred within two years of the petition date consistent with the limits of section 546(c). The court found that no such limitation on computing the amount of the fraudulent transfers, just the amount that can be recovered by the trustee. The two year limitation has nothing to do with whether a given transfer is "for value" for a total invested and received or for matching purposes. If a party received more money than the total amount invested, then the trustee could recover the "profits" so long as the specific transfers to the particular defendant occurred within two years prior to BLMIS bankruptcy petition filing.

SuvicMon Development, Inc. v. Morrison, 991 F.3d 1213 (11th Cir. 2021).

The primary issue in this case is whether the discharge injunction bars the continuation of a fraudulent transfer action in state court against a debtor when the bankruptcy court has ruled the state court judgment is exempt from discharge under section 523(a)(19). The plaintiffs are three corporations that sued debtor Charles M. Morison, Sr., in Alabama state court in 2006 for common-law fraud and violations of the Alabama Securities Act. In 2012, they amended to add claims for fraudulent transfer under the Alabama UFTA against Morrison and his sons, Charles and Bradley. They allege Morrison transferred money and real estate to his sons in an effort to defraud his creditors. Morrison filed chap 7 in August 2018. He was granted a general discharge in December 2018. The bankruptcy court lifted the stay to allow a state case to proceed to judgment but stayed execution. In July 2019, the state case went to trial and a jury verdict was entered against Morrison on common-law fraud and Alabama Securities Act claims for $1,185,176. The court granted judgment as a matter of law in dismissing fraudulent transfer claim against Morrison and Charles, and the jury found in favor of defendants on fraudulent transfer claim as to Morrison and Bradley. The plaintiffs appealed to the Alabama Supreme Court.

In November 2019, the bankruptcy court granted summary judgment for the plaintiffs in their adversary proceeding against Morrison, finding the state-court judgment was excepted from his general discharge under section 523(a)(19). The plaintiffs filed a motion for authority to proceed with the state court fraudulent transfer appeal. The bankruptcy court that discharge injunction barred the plaintiffs from further proceeding against Morrison in state courts on the fraudulent transfer claims but allowed them to proceed against his sons. The district court affirmed.

The plaintiffs argued first, fraudulent transfer suit is an action to collect a non-dischargeable debt and is thus not subject to the discharge injunction; and second, the proceeding nominally against Morrison is permitted under *In re Jet Florida*, 883 F.2d 970 (11th Cir. 1989).

The plaintiffs first argued that because the discharge injunction applies only to discharged debts, if a particular debt is not discharged then any action to collect that debt is permitted. Content that an action to collect a debtor, with plaintiff's state court fraudulent transfer suit being an action to collect on their state court judgment. The court ruled to the contrary. A fraudulent transfer action is not merely a collection action but rather a claim requiring an independent adjudication of liability based on statutorily defined elements. It is a distinct cause of action and in Alabama, in the case of actual fraud, a tort.

The Bankruptcy Code defines "debt" as "liability on a claim." 101(12). But a fraudulent transfer claim is distinct from the claim on which it is predicated. Fraudulent transfer claims give rise to a debt that is distinct from the predicate debt, "and a finding that the underlying debt is non-dischargeable does not meant that the debt arising from the fraudulent transfer is non-dischargeable." Modes of execution, such as writs of execution, attachment, judgment liens, and garnishment, do not constitute a new claim against the debtor or give rise to new debt distinct from the judgment being executed. Mostly, they are not independent causes of action and instead are merely ancillary to the subject judgment being in rem or quasi in rem. However, a fraudulent transfer action can is brought against the debtor in personam. "The plaintiffs' first argument, then,

is unsuccessful: a fraudulent transfer action does not function as an execution proceeding, and the fact that the underlying claim is non-dischargeable does not compel the conclusion that the fraudulent transfer claim is non-dischargeable."

Next, the plaintiffs next sought to proceed in state court nominally against Morrison as an avenue to obtain actual recovery from his sons. The court interpreted *In re Jet Florida* as imposing two requirements before a plaintiff may proceed nominally against a discharged debtor in order to recover from a third party. First, the debtor's status as a defendant to an action must be a genuine prerequisite for plaintiff recovering from third party. Second, the suit must not place a material economic burden on the discharged debtor such that a fresh start is not reasonably possible.

The appellate court upheld the bankruptcy court's denial of the request for permission to maintain and proceed with suit against Morrison, finding that naming him as a defendant was not a prerequisite for recovering from his sons under Alabama UFTA, and requiring Morrison to defend that case would impose a material economic burden because, among other things, no insurance company would cover or defend the case and Morrison was unable to bear the expense of defending himself.

Badgerow v. Walters, 142 S.Ct. 1310 (2022)

Badgerow contends she was unlawfully terminated as a financial advisor under federal and state law. Her employment contract contained an arbitration clause. She initiated arbitration, but the arbitrators sided with defendants and dismissed her claims. Believing fraud tainted the arbitration, Badgerow sued Walters and others in state court to vacate the award. Walters removed the case to federal district court and sought confirmation. Badgerow moved to remand back to state court, arguing the federal court lacked jurisdiction to vacate or confirm under Sections 9 and 10 of the Federal Arbitration Act. The district court looked to *Vaden v. Discover Bank*, 556 U.S. 49 (2009) to determine whether the underlying dispute would have fallen within federal jurisdiction. Applying the "look through approach," the district court found it held jurisdiction because Badgerow's employment action raised federal law claims. The circuit court affirmed.

The Supreme Court held the "look through approach" is not applicable in determining federal court jurisdiction over arbitral awards under section 9 and 10 of the FAA. *Vaden* concerned section 4 of FAA instead of sections 9 and 10. Congress gave federal courts jurisdiction limited to diversity or federal-question cases. The FAA only authorizes parties to arbitration agreements to file specified actions in federal court, such as motions to compel arbitration (section 4) and applications to confirm, vacate, or modify awards (sections 9 through 11).

Section 4 of the FAA explicitly allows a district court to compel arbitration. Section 4 states either party may petition for an order to compel arbitration in a "United States district court which, save for [the arbitration] agreement, would have jurisdiction over the controversy between the parties." The "save for" language authorizes examination of the underlying dispute to find jurisdiction. *See Vaden v. Discover Bank*, 556 U.S. 49 (2009). Congress did not put this same language in Sections 9 and 10 of the FAA, and the sections "do not instruct a court to imagine a

world without an arbitration agreement, and to ask whether it would then have jurisdiction over the parties' dispute." Badgerow, 142 S.Ct. at 1317.

> "The statutory plan, as suggested above, makes Section 9 and 10 applications conform to the normal--and sensible--judicial division of labor: the applications go to state, rather than federal, courts when they raise claims between non-diverse parties involving state law. As Walters notes, those claims may have originated in the arbitration of a federal-law dispute. But the underlying dispute is not now at issue. Rather, the application concerns the contractual rights provided in the arbitration agreement, generally governed by state law. And adjudication of such state-law contractual rights--as this Court has held in addressing a non-arbitration settlement of federal claims--typically belongs in state courts."

Id. at 1321-1322.

The Supreme Court rejected Walter's policy arguments, ruling that policy arguments cannot overcome a clear statutory directive. No federal question was presented, and the parties are not diverse. The FAA does not create independent federal jurisdiction. If so, every arbitration could wind up in district court. The federal application was not about the legality of Badgerow's termination, but the enforceability of the award, which is only a contractual resolution of the dispute. To find a basis for jurisdiction, the trial court must look at the underlying substantive dispute, even if the initial controversy not presently before it.

Morgan v. Sundance, Inc., 142 S.Ct. 1708 (2022)

Morgan worked as an hourly employee at a Taco Bell franchise owned by Sundance. She signed a confidential arbitration agreement. Despite the arbitration agreement, Morgan brought a nationwide collective action against Sundance in federal court for alleged violations of the Fair Labor Standards Act. Sundance filed multiple motions and answered the complaint. Morgan participated in a joint mediation with Sundance and other plaintiffs but refused to settle. Then, nearly eight months after the suit's filing, Sundance moved to stay the litigation and compel arbitration under sections 3 and 4 of the Federal Arbitration Act. Morgan opposed, maintaining Sundance had waived its right to arbitrate by litigating for so long. The district court and Eighth Circuit held a party waived its contractual right to arbitration if it knew of the right; "acted inconsistently" therewith; and was prejudiced by inconsistent actions of the opponent. The district court found the prejudice requirement satisfied, but the court of appeals disagreed and sent the case back for mandatory arbitration. Morgan appealed.

The Supreme Court granted *cert* to consider whether federal courts may create arbitration-specific variants of federal procedural rules, like those concerning waiver, based on the FAA's "policy favoring arbitration." The majority of circuit courts considering the waiver of arbitration issue have applied a rule of waiver specific to arbitration contracts that effectively is more onerous than the waiver analysis applied to other commercial contract terms ad rights. The majority (nine circuits) required a finding of harm as essential: A party can waive its arbitration

right by litigating when its conduct has prejudiced the other side. Two circuits rejected such a rule. The Supreme Court sided with the minority of circuits by definitively rejecting the "special arbitration rule." It held that a federal court may not create new or special procedural rules based on the FAA's "policy favoring arbitration."

Outside of arbitration context, a federal court assessing waiver does not usually ask about prejudice. It only looks to the actions of the person holding a known right to determine if the right has been intentionally relinquished or abandoned. By demanding a finding of detrimental reliance in the arbitration context only, the majority of circuit courts applied a rule found nowhere else. The Supreme Court clarified that the FAA's "policy favoring arbitration" does not authorize federal courts to invent special, arbitration-preferring procedural rules. The policy favoring arbitration is meant to overcome the judiciary's prior refusal to enforce agreements to arbitrate and to put them on the same footing as other contracts. "The policy is to make 'arbitration agreements as enforceable as other contracts, but not more so.'" *Morgan v. Sundance*, Inc. 142 S.Ct. 1708; *quoting Prima Paint Corp. v. Flood & Conklin Mfg. Co*., 388 U.S. 395, 404, n. 12 (1967). Section 6 of the FAA instructs courts to use federal procedural rules and is a bar on using custom-made rules to tilt playing field in favor of (or against) arbitration. The bottom line is that courts should hold a party to its arbitration contract just as it would any other kind, and the federal policy is about treating arbitration contracts like all others, not about fostering arbitration.

Faculty

Hon. Joseph N. Callaway is a Bankruptcy Judge for the U.S. Bankruptcy Court for the Eastern District of North Carolina in Greenville, appointed in January 2016. Previously, he practiced law at Battle Winslow Scott and Wiley in Rocky Mount and Raleigh, N.C., where he remained for more than 32 years and was the head of the firm's creditor rights and bankruptcy practice department for many years. While in private practice, he was licensed in and participated in cases before all levels of state and federal courts in North Carolina, the U.S. Court of Appeals for the Fourth Circuit, and the U.S. Supreme Court. In addition, he served as a chapter 7 bankruptcy trustee and was a certified specialist in business and consumer bankruptcy law for more than 20 years. Judge Callaway was regularly listed as an "Elite Business Attorney" and a *North Carolina Super Lawyer* in the area of bankruptcy law for numerous years. He also served as an officer and director of the Bankruptcy Section of the North Carolina Bar Association. Judge Callaway is a frequent speaker at bankruptcy and business law seminars on various bankruptcy and commercial litigation topics. He received his B.A. in political science from the University of North Carolina at Chapel Hill in 1980 and his J.D. from the University of North Carolina School of Law in 1983.

Leanne Gould, CPA, ABV, CFF, ASA is the principal of Gould Consulting Services (GCS) in Atlanta, which she founded in 2018 to help counsel and their clients to understand complex financial and business valuation issues in a variety of disputed matters by listening, evaluating the facts and documents produced in the case, and explaining findings and opinions clearly and in a practical manner. She began her career in medical device manufacturing in new product development and operations. This experience formed the foundation for her understanding of the manufacturing process and data flow from the design, production, strategy development and launch of new products to overseeing day-to-day accounting, operations and financial issues. Ms. Gould transitioned into bankruptcy consulting advising distressed companies through the restructuring or bankruptcy process; a financial advisory role that benefited from her background and experience. During this time, she also provided litigation support services in commercial and bankruptcy disputes. Ms. Gould has served as financial advisor to chapter 7, 11 and 13 trustees, committees and creditors/claimants in matters before U.S. bankruptcy courts and has been appointed forensic accountant and independent accountant for arbitration panels and disputing parties. She provides expert reports and testimony in depositions, hearings and jury trials in matters before U.S. bankruptcy courts, U.S. district courts, superior and state courts, and arbitration panels across the nation on a variety of issues, including voidable transfers, conversion, misappropriation, disputed business valuation, lost profits and avoidance actions brought under §§ 544, 547 and 548 of the U.S. Bankruptcy Code and U.V.T.A., including assessments of reasonably equivalent value, solvency, asset-tracing and alter-ego. Ms. Gould received her M.B.A. from the University of Buffalo.

Robert M.D. Mercer is a sole practitioner with Mercer Law, LLC in Atlanta, where he focuses his practice on high-dollar bankruptcy and insolvency litigation. In his more than 25 years of practice, he has represented just about every major player in chapter 11 cases, including post-confirmation trustees, creditors' committees, chapter 11 debtors, indenture trustees, receivers, asset-purchasers, directors and officers, pre-petition lenders and debtor-in-possession lenders. Mr. Mercer has been listed in *Chambers USA's Guide to America's Leading Lawyers for Business* and as a "Georgia Su-

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Jeffrey W. Warren is a founder and president emeritus of Bush Ross, PA in Tampa, Fla. He has a nationally recognized legal practice in chapter 11 reorganization cases, both as a courtroom counsel and as an out-of-court negotiator and problem-solver. Mr. Warren is admitted to practice in Florida, the U.S. District Courts for the Middle, Northern and Southern Districts of Florida, the U.S. Courts of Appeals for the Fourth, Fifth, Tenth and Eleventh Circuits, and the U.S. Supreme Court. He also has been inducted as a Fellow of the American College of Bankruptcy and was a contributing editor for the *ABI Journal*. Mr. Warren is Board Certified in Business Bankruptcy Law by the American Board of Certification and is a certified circuit mediator by the Florida Supreme Court. He is the author of several chapters for publication of the Florida Bar and numerous articles regarding creditors' rights issues. In 2008, the Tampa Bay Bankruptcy Bar Association presented Mr. Warren with the Douglas P. McClurg Professionalism Award. He has been recognized in *The Best Lawyers in America* since 1995 and received "Lawyer of the Year" recognition in the fields of Bankruptcy Creditor/Debtor Rights and Bankruptcy Litigation in 2011 and 2013, respectively. He has also been named to Florida's "Legal Elite" by *Florida Trend Magazine* since 2005. Mr. Warren has been recognized as one of the Top 100 Florida Lawyers every year since 2007 and as a Top 10 Florida Lawyer in 2008, 2009, 2013, 2014 and 2015 by *Florida Super Lawyers Magazine*. He also is rated AV-Preeminent by Martindale-Hubbell. Mr. Warren received both his B.S. in 1969 and his J.D. in 1972 from the University of Florida.

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