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Preference, Earmarking and Fraudulent Transfer Law: Making Progress Together for Future Bankruptcies

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CONCURRENT SESSION

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Domestics and Foreign Asset Protection Trusts:
An Overview on Their Creation and How to Break Them Down

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A. Domestic Asset Protection Trusts (DAPTs) - Overview

- What is a DAPT?
  - an irrevocable trust with an independent trustee with absolute discretion to make distributions to a class of beneficiaries which include the settlor
- How many states have a DAPT statute?
  - 19 of the 50 states allow DAPTs (as of Fall 2019)
    - 41% of geographical area of U.S.
    - 23% of the population
- The first state to enact a DAPT statute - Alaska in 1997
- The most recent states to enact DAPT statutes – Indiana (effective July 1, 2019) and Connecticut (effective January 1, 2020).
- Prior to that:
  - Ohio in 2013
  - Mississippi in 2014
  - West Virginia in 2016
  - Michigan in 2017
- What about the states that don't have a DAPT statute?
  - 17 of the 50 states allow asset protection through self-settled techniques
- Sketchy authority exists interpreting these statutes.
  - 6 known cases currently:
    - 3 regarding Alaska statute - creditors' prevailed in fraudulent transfers cases
    - 1 regarding Delaware statute - SOL barred the creditors
    - 2 regarding Nevada's statute
      - (1) holding that DAPT assets could not be reached for satisfaction of future spousal support claims & child support claims
      - (2) applying Utah law to the Nevada DAPT statute for a divorce action.
- Public policy behind DAPTs - all about equity and "right" to keep money safe
- Key component in many statutes is the limited SOL
- Exceptions; creditors (depending on the state)
  - Child support obligations
  - Fraudulent conveyances

  - Spousal claims
  - Tort claims - arising from injuries on or before the date of the transfer of the trust
- Many issues hover around DAPTS
  - Whether nonresidents of DAPT states may form a DAPT under one of the DAPT state's laws and obtain the desired asset protection and tax benefits.
  - *Conflict of laws*; the choice of law rules most frequently discussed in this area are two sections of the Restatement (Second) of the Law, Conflict of Laws**. Section 273** discusses when the creditors of a beneficiary can reach the assets of a trust, and directs that this issue is governed by the law of the state chosen by the settlor in the trust instrument.

    However, cases in the foreign trust area, and the one DAPT case dealing with this subject, refer to **section 270(a**), which deals with the validity of an inter vivos trust.

    This section's test is whether the nonresident's state of residence has a "strong public policy" against DAPT asset protection. Since several cases have applied the section 270 rule, it will be important to explore just what is a "strong public policy."

- Are there fraudulent transfer statutes that apply to DAPTs?
  - Yes, the **Uniform Fraudulent Transfer Act k/n/a Uniform Voidable Transfer Act (2014)**; though amendments being made state-to-state to support DAPTs
    - This has been enacted in 20 states, 5 of which are DAPT states.
  - Some states require an Affidavit verifying that the DAPT isn't being used to shield assets.

B. Various States DAPTs

- **Alaska**: Alaska Trust Act - 1997
    - Allows protection for irrevocable spendthrift trusts
  - *Requirements*:
    - 1) must be irrevocable
    - 2) must expressly state Alaska law governs validity, construction, and administration of the trust (unless trust is being transferred to AK trustee from non-DE trustee)
    - 3) must contain spendthrift trust clause
  - *Benefits*:
    - Alaska does not recognize exception creditors (Exceptions for child support– if the settlor was 30 days or more in default at time of transfer of assets to trust *and* for property division upon divorce – if assets were transferred to trust during or less than 30 days prior to marriage).
    - settlor can retain certain powers while continuing to have protection
  - *To establish situs*:
    - some/all of trust assets deposited in state;
    - AK trustee whose powers include:
      - maintaining records;
      - preparing/arranging income tax returns
    - part/all of the admin occurs in AK, including maintaining records
  - *Exceptions*:
    - courts have avoided transfers where:
      - the bankruptcy trustee proved actual intent to defraud; and
      - Washington public policy warranted voiding a transfer in Alaska where the debtor had no ties
      - courts of another state, or the Bankruptcy Court, have jurisdiction of the subject matter and the parties.
  - *SOL*: 4 years or 1 year
    - *Existing creditors:*
      - 4 years after the transfer or 1 year after the transfer was or could reasonably have been discovered
        - To qualify for the discovery exception: the existing creditor must: (i) demonstrate that the creditor asserted a specific claim against the settlor before the transfer; or (ii) within 4 years after the transfer file another action against the settlor that asserts a claim based on an act or omission of the settlor that occurred before the transfer
    - *Future Creditors*:
      - 4 years after the transfer
  - Must prove transfers made with intent to defraud
  - Alaska has not adopted the UFTA
  - Burden of proof - **clear and convincing evidence**

- **Connecticut**: Connecticut Uniform Trust Code – Jan. 1 2020
    - allows protection for irrevocable spendthrift trusts
  - *Requirements*:
    - 1) must be irrevocable
    - 2) must provide that the laws of CT govern its validity, construction, and administration
    - 3) must provide that the interest of the transferor/beneficiary not be able to be transferred, assigned, pledged or mortgages prior to distribution by the trustee.
  - *Benefits*:
    - Settlor can retain certain powers while continuing to have protection
  - *To establish situs*:
    - at least 1 qualified trustee
    - trustee must maintain at least some/all of the trust assets and records in CT; and
    - trustee must materially participate in the admin of the trust
  - *Exceptions*:
    - Exception creditors are permitted to go after the trust for:
      - alimony – when the debt was outstanding on or before the date of the qualified disposition and only to the extent of the debt
      - child support – when the debt was outstanding on or before the date of the qualified disposition and only to the extent of the debt
      - tort claimants for claims that arise as a result of death, PI or property damage occurring before the date of transfer
      - property upon divorce –when the debt was outstanding on or before the date of the qualified disposition and only to the extent of the debt
  - *SOL*: 4 years or 1 year
    - *Existing creditors*:
      - 4 years after the qualified disposition, or 1 year after the qualified disposition was or could reasonably have been discovered by the creditor
    - *Future creditors*: creditor may not bring action unless it was within 4 years of the qualified disposition
  - Burden of proof - **clear and convincing evidence**
  - Only actions brought under the CT's Uniform Fraudulent Conveyance Act (1991) can be used against trust property.

- **Delaware**: Delaware Qualified Dispositions in Trust Act - 1997
    - allows protection for irrevocable spendthrift trusts
  - *Requirements*:
    - 1) must be irrevocable
    - 2) must expressly state that DE law governs validity, construction, and administration of trust (unless trust is being transferred to DE trustee from non-DE trustee)
    - 3) must contain spendthrift clause

- *Benefits*:
    - Settlor can retain certain powers while continuing to have protection
- *To establish situs*:
    - Some/all of trust assets held in custody in state
    - DE trustee whose powers include:
        - maintaining records
        - preparing/arranging for the prep of income tax returns; or
        - otherwise materially participate in admin of the trust
- *Exceptions*:
    - Exception creditors are permitted to go after the trust for:
        - alimony – when the debt is outstanding at the time of the qualified disposition and only to the extent of the debt
        - child support – when the debt is outstanding at the time of the qualified disposition and only to the extent of the debt
        - tort claimants for claims – that suffers death, PI, or property damage on/before qualified disposition (also includes if settlor is vicarious liable)
        - property division upon divorce – based on settlor being indebted to that person at the time of the qualified deposition and only to the extent of the debt
- *SOL*: 4 years or 1 year
    - *Existing creditors*:
        - 4 years after transfer, or 1 year after transfer was or could reasonably have been discovered if claim based upon intentional fraud
        - 4 years after transfer if claim based upon constructive fraud.
    - *Future creditors*: 4 years after transfer
- Burden of proof - **clear and convincing evidence**
- UFTA applies to creditors whose claims exist at time of qualified disposition

- **Indiana**: Indiana Legacy Trust statute – July 1 2019
    - allows protection for irrevocable spendthrift trusts
    - *Requirements*:
        - 1) must be in writing, signed by the settlor, and designate that it's a Legacy Trust;
        - 2) state that IN law governs validity, construction, and admin of the trust; and
        - 3) must be irrevocable
    - *Benefits*:
        - Settlor can retain certain powers while continuing to have protection
    - *To establish situs*:
        - Qualified trustee must be appointed and accepted
    - *Exceptions*:
        - Exception creditors are permitted to go after the trust for:
            - fraudulent transfers
            - child support

- property upon divorce – if the qualified disposition was made after the marriage, assets are subject to division; if the qualified disposition was w/in 30 days before the settlor's marriage, the assets are subject to division unless the settlor provided written notice to the spouse at least 3 days before making the qualified disposition
- assets listed on an application or fin. statement for a loan *and* if those assets are transferred to a Legacy Trust, settlor must send written notice 15 days after the transfer to the lender
- assets subject to an agreement stating that the disposition is prohibited

- *SOL*: 2 years or 6 months
  - *Existing creditors*:
    - the later of 2 years after the transfer was made or 6 months after the transfer was recorded or could have been reasonably discovered
  - *Future creditors*: 2 years from the date of the transfer
- Burden of proof - **clear and convincing evidence**

- **South Dakota**: Qualified Dispositions in Trust Act of 2005
    - allows protection for irrevocable spendthrift trusts
  - *Requirements*:
    - 1) must be irrevocable
    - 2) must expressly state that SD law governs validity, construction, and administration of trust (unless trust is being transferred to SD trustee from non-SD trustee);
    - 3) must contain spendthrift clause
    - 4) must have a "qualified person" as a trustee
    - Can't be used for asset protection
  - *Benefits*:
    - There is no rule against perpetuities
    - settlors can retain certain powers while continuing to have protection
  - *To establish situs*:
    - some/all of the trust property must be in South Dakota
    - some/all of the trust administration should be performed in South Dakota
  - *Exceptions*:
    - the settlor must be a discretionary beneficiary
    - At least 1 trustee must be a resident or institution in South Dakota
    - exception creditors are protected for:
      - alimony – if ex-spouse was married to settlor before/at time of transfer of assets to trust, but only to the extent of the debt existing at the time of the transfer
      - child support – to the extent of the debt existing at the time of the transfer

            - property division upon divorce – if ex-spouse was married to settlor before/at time of transfer of assets to trust, but only to the extent of the debt existing at the time of the transfer
                - settlors separate property is protected in divorce regardless of marriage date
                - any martial property transferred to DAPT is protected if settlor's spouse receives statutory notice or provides written consent after getting notice
    - *SOL*: 2 years or 6 months
        - UFTA applies and sets aside transfers with intent to defraud a specific creditor
        - Burden of proof - **clear and convincing evidence**
            - *Existing creditors*: 2 years after transfer, or 6 months after transfer was or could reasonably have been discovered if creditor (1) asserted specific claim before transfer; or (2) if creditor files another action within 2 years that asserts claim before transfer.
            - *Future creditors*: 2 years after transfer.

- **Oklahoma**: Family Wealth Preservation Act – June 9, 2004
    - *Requirements*:
        - 1) must expressly state that OK law governs
        - 2) must have a trustee or co-trustee as a OK based bank that maintains a trust dept. or an OK-based trust company at all times
        - 3) must have only qualified beneficiaries [ancestors or lineal descendants of grantor (including adopted lineal descendants if they were under age 18 when adopted), spouse of the grantor, charities, or trusts for such beneficiaries];
        - 4) must recite that income is subjected to income tax laws of OK
    - *Benefits*:
        - can be a revocable or irrevocable trust
        - revocable trust can be used for asset protection
    - *To establish suits*:
        - OK-based trustee
        - majority of value of assets comprised of OK assets
    - *Exceptions*:
        - exception creditors are protected for:
            - child support
    - *SOL*: 4 years or 1 year
        - *Existing* and *future creditors* are treated the same:
            - 4 years after transfer, or 1 year after transfer was or could reasonably have been discovered if claim is based upon intentional fraud
            - 4 years after transfer if claim is based upon constructive fraud.
    - UFTA applies and sets aside transfers with intentionally or constructive fraud
    - Burden of proof – **clear and convincing evidence**

C. Nevada – "What Goes in a Nevada DAPT *STAYS* in a Nevada DAPT!"

- **Nevada**: Spendthrift Trust Act of Nevada - effective Oct., 1 1999
    - allows protection for irrevocable spendthrift trusts
- 3 Trust Instrument Requirements:
    - 1) must be irrevocable
    - 2) all or part of corpus of trust must be located in Nevada, settlor's domicile must be in Nevada, OR trust instrument must appoint a Nevada trustee; and
    - 3) distributions to settlor must be approved by someone other than the settlor
- *Benefits*: Does not recognize exception creditors and settlor can retain certain powers while continuing to have protection
- Restrictions:
    - A revocable trust cannot be used for "asset protection" (again, really???)
- Restrictions on creditors:
    - Exception creditors do not apply
        - There is no exception for a child support claim, alimony claim, property division upon divorce, or tort claims.
    - A charging order is the only remedy for a creditor of an owner as to LLCs, partnerships, and limited partnerships
- Supported by the state legislature through continued amendments in 2007, 2009, 2011, 2015, and 2019 – nothing has been weakened
- A Nevada DAPT:
    - can last up to 365 years
    - can have distribution advisor, investment advisor, or a trust protector
    - Is there statutory authority to support a trust's non-contestability clause even if probable cause exists for contest? It depends (per 2019 amendment):
        - "[A] no-contest clause in a trust must be enforced, to the greatest extent possible, by the court according to the terms expressly stated in the non-contest clause without regard to the presence or absence of probable cause for, or the good faith or bad faith of the beneficiary in, taking the action prohibited by the non-contest clause." However, subsection (b) does provide a probable cause exception limited to challenges to validity of trust related docs.
    - due diligence is NOT required
- Requirements to establish "situs":
    - 1) all or part of assets are in NV
    - 2) Nevada trustee whose powers include
        - maintaining records, and
        - preparing income tax returns
    - 3) all or part of the administration must be in state
- Nevada law allows the settlor to:
    - have a lead interest in a CRT
    - the right to minimum required distribution under a retirement or deferred - compensation plan
    - the lead interest in a GRAT
    - the lead interest in a QPRT
    - the right to receive distributions in the discretion of another person

  - the right to use real or personal property owned by the trust
  - have a veto power over distributions
  - a limited lifetime or testamentary power of appointment
  - the power to remove and replace a trustee
  - direct trust investments
  - and other management powers (but NOT the power to make distributions without the consent of another person)
- Who can be a trustee?
  - The trustee must be a resident individual, a trust company, or a bank that has an office in Nevada
  - There are no restrictions on co-trustees
- What is a trustee's **distribution authority**:
  - it can be absolute discretion or limited discretion by an ascertainable standard, **and it may be subject to approval or veto powers retained by the settlor or given to the trust protector or other advisor**
  - A trustee can pay income or principal directly to a third party, for the benefit of a beneficiary, even if the beneficiary has an outstanding creditor
  - A trustee is not given a lien against the trust assets for costs & fees incurred to defend the trust
    - However, a trustee or an advisor of the settlor or trustee is liable only if it is established by **clear and convincing evidence** that damages directly resulted from the advisor's violation of the law knowingly and in bad faith
  - The trustee is given "decanting" authority to modify the trust
- **Fraudulent transfers**
  - Nevada law (per UFTA) sets aside certain fraudulent transfers
  - The burden of proof: **clear and convincing evidence**
  - **SOL:**
    - ***future creditors*** **- 2 years after transfer**
    - ***existing creditors*** **- 2 years after transfer, or if longer, 6 months after transfer was or could've reasonably been discovered if the claim was based on intentional fraud rather than constructive fraud**
    - **A transfer is discovered when it is reflected in a public record**
  - Nevada has NOT adopted the 2014 amendment to the Uniform Fraudulent Transfer Act (now the Uniform Voidable Transactions Act)
- Can a trust outside of Nevada later get moved to Nevada and be subject to NV DAPT statute?
  - Yes
- What's the right of a beneficiary?
  - The settlor can use real property and tangible personal property owned by the trust, which doesn't expressly require approval in the trustee's discretion
- A non-settlor beneficiary's interest is protected from property division at divorce if:
  - The property is retained in a spendthrift trust for the beneficiary. Even if it's not retained in the trust, property received by gift or inheritance is the beneficiary's separate property. However, trust income and assets can be considered a resource for purposes of determining alimony and child support.
- Nevada cannot get income tax against DAPTs formed by non-resident settlor

D. Breaking Down DAPTs

- Under Local Law for Domestic Asset Protection Trusts
  - **Child support obligations** – mainly only applies to the extent of the debt
    - Rhode Island: exception only applies if there was a court order at the time of the transfer
      - West Virginia: spendthrift provision unenforceable against a beneficiary's child who has a judgment a court order; grantor's affidavit must include this, if it exists.
    - Utah: not protected against child support claims, but trustee must give 30 days' advance notice to domestic support obligation creditor; this creditor can't force distribution from the trust or attach trust assets
    - Alaska & Michigan: trust assets aren't protected from child support claims if at the time of the transfer the settlor was in default by 30 days or more in making those payments.
      - If this is the case in MI, it's not considered a qualified disposition.
    - Nevada: no spendthrift trust exception for child support
      - The exception also doesn't apply in Wyoming, but only for a Discretionary APT; it does apply to a Qualified Spendthrift Trust
  - **Fraudulent conveyances statutes**
    - Asset protection trust statutes do NOT override the state's fraudulent conveyance statutes, but differs on how the fraudulent conveyance statute is applied and some are being modified to support the spirit of DAPTs.
    - The burden of proof for fraudulent conveyance regarding an asset protection trust in most states is clear and convincing evidence
    - Nevada – only a 2 year SOL period from the time of the transfer or 6 months after the transfer reasonably should've been discovered
  - **Spousal claims (not protected)**
    - Wyoming, West Virginia, Virginia, Oklahoma, Nevada & Utah: marital property divisions or distributions *and* alimony are not protected
  - **Tort claims from injuries occurring on or before the date of transfer of the trust**
    - Delaware, Connecticut, Rhode Island & Hawaii: doesn't insulate trust property from a person who suffers tort injuries (death, personal injury, or property damage) on or before the date of the transfer to the trust – in cases where the injury or damage is caused in whole or in part by an act or omission of the transferor or by someone from whom the transferor is or was vicariously liable
    - Alaska, Indiana, Michigan, Wyoming, West Virginia, Virginia, Nevada, Utah, South Dakota, Tennessee, New Hampshire, Ohio, Missouri, and Oklahoma: don't have this provision at all.
  - **Sham or alter-ego transaction**
    - **Applicability**: when the settlor has retained excessive control in the trust document or through inappropriate trust administration and a failure to adhere to trust formalities
    - **Result**: trust assets are subject to levy
  - **The transfer is against public policy**

- **Applicability**: applies to states where self-settled trusts are not recognized – the trust can be disregarded for public police reasons. State public policy provides an exception to the choice of law language in the trust instrument to prevent the other court from having jurisdiction
- **Process**:
  - 1) establish that the court has jurisdiction
  - 2) determine whether the law designated in the trust or the law of the court with jurisdiction should govern
    - **Factors**: Settlor residency, trust asset location, creditor residency, operation of business, trust administration, and location of legal professionals

<u>E. Foreign Asset Protection Trusts</u> / Offshore Asset Protection Trusts (OAPTs)

- **Substantially similar to DAPTs though have been around much, much longer – that's where we got the idea!**
- **Cook Islands**:
  - *Benefits*:
    - Does NOT recognize treaties or statutes to enforce foreign judgments (or foreign inheritance laws) against settlors, donors, trustees, protectors, or beneficiaries.
      - Only judgments in New Zealand courts can be enforced, which tend to be favorable to settlors/trustees/beneficiaries of an international trust.
    - Foreign bankruptcy rules are excluded
    - The assets do NOT have to be in the Cook Islands
    - No rule against perpetuity
    - The creditor MUST bring an action in the Cook Islands to set aside the trust
    - If unsuccessful, the creditor may have to pay the legal costs of the trusts if the court mandates it
    - The settlor can also be a beneficiary of the trust – as well as the sole beneficiary
    - Privacy: details of the beneficiaries and settlor aren't registered. It's an offense for a person to disclose any information re the establishment, constitution, or business undertaking or affairs of the trust punishable by fines and/or jail time
      - UNLESS authorized to by the High Court of Cook Islands or for administrative purposes when the trustee needs to seek advice of legal counsel
    - Trust owners:
      - Those convicted of Medicaid Fraud
      - Ponzi Schemes
      - Bilking employee pension funds
      - Doctors worried of getting sued for malpractice
  - *Drawbacks*:
    - There must be a resident licensed trustee (unless custodian trustee exception applies): the trust must use 1 of 5 registered trust companies that operate out of the islands
    - The beneficiaries must be non-residents of the Cook Islands at ALL times
    - The settlor must sign a sworn affidavit of solvency – regardless of who is the trustee
      - Each time an asset is valued at more than $10K (USD) is transferred into the trust, another affidavit is required
    - The trustees must do due diligence
    - The trust must be registered with the Registrar of International Trusts within 45 days of it being created
  - *SOL*:
    - 2 years

- *Burden of proof*: **beyond a reasonable doubt**
  - the creditor must prove that the settlor did it with an intent to defraud him and that the transfer rendered the settlor insolvent or without assets that the creditor's claim could have satisfied
- **Interesting Tidbit: Most settlors don't even know where to find the Cook Islands.**

- **Bahamas**:
  - *Benefits*:
    - The trust cannot be void, voidable, or liable to be set aside under foreign law
    - For a U.S. judgment to be recognized, the creditor must bring a local action to enforce it
    - No settlor or trustee or any beneficiary can be subject to liability based on laws of any foreign jurisdiction that doesn't recognize the trust, the trust avoids rights from someone with a personal relationship with the settlor or by heirship rights, or if the trust contravenes a rule of foreign law, judicial, or administrative order or action
    - The settlor retains various powers
    - Settlor can be a beneficiary of the trust and either can be foreigners
      - BUT the settlor cannot benefit from a spendthrift provision in the trust
    - Strict bank secrecy laws
    - The rule against perpetuities was abolished
    - Very difficult to prove that the trust is a sham
    - Non-Bahamian trust beneficiaries are exempt from taxes – income tax, capital gains tax, estate tax, inheritance tax, succession tax, gift tax, rate, duty, levy, or other charge is payable by any beneficiary who is treated as non-resident for exchange control purposes in respect of any distribution to him or her by the trustee of any trust
      - But U.S. residents and others are subject to global income tax that they must declare to their respective governments
    - Trusts or other deeds executed by the trustees, settlors, beneficiaries, or protectors are exempt from registration under Bahamian law
      - Except conveyances of Bahamian real property or personal property must be registered.
  - *SOL*: 2 years
    - The creditor must prove fraudulent intent

- **Nevis**:
  - *Benefits*:
    - Does NOT recognize foreign judgments
      - Creditor's main remedy is fraudulent transfer action locally
    - The settlor or the trustee of the trust can also be a beneficiary – and settlor can be the only beneficiary
    - Settlor retains various powers

        - Creditor must prove the fraudulent transfer **beyond a reasonable doubt** by proving actual fraud against this credit & the settlor's insolvency (same as Cook Islands)
        - The creditor must post a bond to pursue any action against the trust property
        - It provides secrecy laws to protect the confidentiality of the info related to a trust registered under the act
        - Forced heirship rules of the settlor's home country are ignored
        - No rule against perpetuities
    - *Drawbacks*:
        - Must be registered under Nevis' laws within 45 days
        - Must have at least one trustee
        - Settlor and beneficiaries must be nonresidents at all times
        - The trust cannot own any land in Nevis and St. Kitts
    - *SOL*: 2 or 1 year
        - A trust settled or established and a disposition to such trust shall not be fraudulent as against creditor of a settlor–
        - (a) if settled, established or the disposition takes place after the expiration of 2 years from the date that such creditors cause of action accrued; or
        - (b) where settled, established or the disposition takes place before the expiration of 2 years from the date that the creditors cause of action accrued, the creditor fails to commence such action before the expiration of 1 year from the date such settlement establishment or disposition took place.

    - *Burden of proof*: beyond a reasonable doubt

- **Belize (not offshore, though neither is the U.S., home to some of the best DAPTs):**
    - *Benefits*:
        - Belize will NOT enforce foreign judgments
        - The assets don't have to be in Belize
        - The court will NOT recognize any claim against the assets of the trust, or the order of a court of another jurisdiction respecting the trust, with regard to marriage, divorce, forced heirship, and creditor claims in the event of a settlor's insolvency
        - Settlor can also be a beneficiary
        - Rule against Perpetuities does not apply
        - The trust is exempt from taxes and duties of Belizean laws
        - Trusts are NOT open for public inspection
            - Except the trustee or trust agent may authorize, in writing, a person to inspect the entry of that trust on the register
    - *Drawbacks*:
        - Non-charitable trusts can only last for 120 years from the date of its creation
        - It has its own fraudulent transfers law that applies if actual intent is proven & its own law for invalidating international trusts

- *SOL*: None – assets are immediately protected upon being transferred
  - the creditor must prove actual fraud
  - the courts won't entertain freeze orders

- **Bermuda:**
  - *Benefits*:
    - A Bermuda trust cannot be varied or set aside by a Bermuda court pursuant to a law of another country regarding the effect of marriage, forced heirship, or insolvency of the settlor and creditor protection unless other Bermuda law or Bermuda public policy considerations apply
    - Does NOT recognize foreign judgments
      - Does NOT recognize actions based on law from a jurisdiction that prohibits the trust;
      - Actions that the trust avoids rights, claims, or interests brought by a personal with a personal relationship to the settlor or any beneficiary or by way of heirship rights; or
      - Actions that the trust avoids rights, claims, or interests brought by a creditor in matters of insolvency
    - No taxes on profits, income or dividends, nor is there any capital gains tax on trusts – but there is a nominal stamp duty on certain trust documents where the trust fund holds non-Bermuda property
    - For a U.S. judgment to be recognized, the creditor must bring a local action to enforce it
    - No requirement that the trustees be residents in Bermuda, but a stamp duty may apply if that's the case
  - *Drawbacks:*
    - The trust must be created for a certain purpose either non-charitable purpose or purses provided that:
      - sufficiently certain to allow the trust to be carried out;
      - lawful; and
      - not contrary to public policy.
    - The Rule Against Perpetuities applies – but ONLY to the extent that the property is land in Bermuda
    - Subject to certain exceptions, it is a criminal offence to act as a trustee in Bermuda as a business, trade, profession or vocation without a license. One such exception is where a co-trustee is licensed.
    - No bank secrecy laws, but banking info is not readily available to third parties under English common law protection
  - *SOL*: 2 years
    - Creditor can challenge a transfer to a trust of an asset below market value and must prove the dominant purpose of the transfer was to defraud creditors

F. Breaking Down FAPTs

- **U.S. Treaties/Acts with Foreign Jurisdictions:**
  - **FATCA – Foreign Account Tax Compliance Act**
    - **Purpose**: to target non-compliance by U.S. taxpayers using foreign accounts
    - **Applicability:** requires foreign financial institutions (FFIs) to report to the IRS information about financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. FFIs are encouraged to either directly register with the IRS to comply with the FATCA regulations (and FFI agreement, if applicable) or comply with the FATCA Intergovernmental Agreements (IGA) treated as in effect in their jurisdictions
    - In force by *Bermuda, Nevis* & the *Bahamas* from the above list of popular foreign states for FAPT
  - AML (Anti-Money Laundering) Compliance
    - **Purpose**: to end global tax evasion – giving the US IRS an increased ability to detect US tax evaders concealing their assets in foreign accounts and investments under the FATCA - 26 USC Ch. 4 in 2010
    - **How**: done by encouraging non-US entities to comply with a new set of tax information reporting and withholding rules or suffer the consequences of non-compliance, primarily being subject to withholding tax on income from US sources.
      - Ultimately the consequence of non-compliance will include withholding on gross proceeds from the sale of US securities and income from non-US sources.
- **Contempt Powers** – civil contempt orders
  - **Applicability**: once the U.S. court gets jurisdiction over the person of the debtor, the courts will consider using civil contempt orders to induce the trustee of the foreign trust to repatriate the assets to the U.S. in satisfaction of the judgment
  - **Compel repatriation of foreign assets** or contempt of court for failing to comply with the repatriation order
    - Repatriation order – settlor is ordered to appoint a US trustee for the offshore accounts OR repatriate the assets held in those trusts to satisfy the judgment, as long as the settlor makes a significant effort to repatriate the funds to the US – ***See U.S. v. Grant***
    - **Held**: The settlor had sufficient power to repatriate the corpus of the offshore trusts such that once those funds are in the U.S. they must be applied to her tax debt. She had control over the offshore trusts by having $221,000 in trust funds deposited into her children's accounts.
- **MLATs** – Mutual Legal Assistance Treaties, usually limited to use in criminal proceedings
- **Embargo Orders**
  - Some Americans have gone around US embargo orders and placed the proceeds into offshore accounts
    - *Example*: Marc Rich traded with Iran and placed the $100 million he made into an offshore account in the Cook Islands

- **BEWARE OF LOCAL LAWS REGARDING GATHERING OF INTELLIGENCE**
- Limited Fraudulent Transfer Statutes in foreign jurisdiction, *but see*….

§ 548(e) - Fraudulent Transfers in Bankruptcy

- **Purpose**: purpose when created in 2005 was to close "the self-settled trusts loophole" and was directed at the [then] five states that permitted such trusts, including Alaska. Its main function, per the court, "is to provide the [bankruptcy] estate representative with an extended reach back period for certain types of transfers."
- **11 U.S.C. § 548(e)** - In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if -
  - (A) such transfer was made to a self-settled trust or similar device;
  - (B) such transfer was by the debtor;
  - (C) the debtor is a beneficiary of such trust or similar device; and
  - (D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted
- U.S. Bankruptcy courts don't have jurisdiction to avoid transfers in foreign asset protection trusts
  - Ways to get around this obstacle:
    - *Nastro v. D'Onfrio*, 263 F. Supp 2d 446, 455 (D. Conn. 2003) - the court granted that judgment creditor injunctive relief under UFTA regarding transfers of LLC interests to a foreign trusts.
    - The court also indicated that although the certificates may be outside the jurisdiction of the court, "the court could order the corporations to delete the trustee as the owner of the stock in the corporate ledger and issue new certificates in favor of [debtor]." Thus, the creditor could seize the certificates.
    - The court held that under the UFTA the court had broad powers to remedy the fraud, including issuing new certificates that would be subject to seizure by the creditors.
    - The court found that the foreign trustee would be bound by its decision even if the court didn't have jurisdiction over the trustee because "the trust beneficiaries, who are also named as defendants to this action and whose interest in this litigation is identical to the trustee, could protect the trustee's interest.

Additional Authority:

- In *In re Mortensen*, an Alaska court considered whether a debtor can use the Alaska DAPT statute as a shield against creditors in bankruptcy. The court refused to allow the debtor to use his trust to shield his creditors.
    - *Facts*: In 2005 debtor put his property in Alaska, worth $60,000 at the time, into a self-settled trust. The purpose of the trust was to "to maximize the protection of the trust estate or estates from creditors' claims of the Grantor or any beneficiary and to minimize all wealth transfer taxes." His beneficiaries were himself and his descendants. His brother and fried were co-trustees and his mother was trust protected. Pursuant to the Alaska DAPT statute, the debtor had to submit an affidavit that, among other things, he had no intent to defraud creditors by creating the trust. Then in 2009, he filed for bankruptcy under Chapter 7.
    - *Issue*: did the debtor create the trusts with actual intent to hinder, delay, or defraud his creditors
    - *Rule:* The court applied 548(e) because "[i]t would be a very odd result for a court interpreting a federal statute aimed at closing a loophole to apply the state law that permits it. . . [A] settlor's expressed intention to protect assets placed into a self-settled trust from a beneficiary's potential future creditors *can* be evidence of an intent to defraud (ex: substantial credit card debt which he did not attempt to pay off with $100,000 he just received from his mother, but instead put that money in the trust) showed evidence of intentional fraud.
    - *Held:* From looking at the debtor's financial condition leading up to his creation of the trust, the debtor created the trust to defraud present and future creditors.
    - *In re Mortensen*, 2011 WL 5025249 (Bankr. D. Alaska 2011).
- **Burden on trustee**: the trustee must prove § 548(e) by a **preponderance of the evidence** even though the burden of proof under state DAPT statutes is clear and convincing evidence. *In re Pollack*, 2016 WL 270012, *4 (Bankr. D.N.H. 2016)

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Avoidance Action Issues: Earmarking Doctrine, Conduit Defense, and Small Business Reorganization Act of 2019 (SBRA)[1]

Earmarking Doctrine

The earmarking doctrine is a judicially-created defense to avoidance actions and concerns the issue of whether the transferred property was property of the debtor or of the estate. *See* 11 U.S.C. §§ 547(b) ("any transfer of an interest of the debtor in property"); 548(a)(1) ("any transfer of an interest of the debtor in property"); & 549(a) ("a transfer of property of the estate"). Earmarking describes the situation where a new creditor pays a debtor's existing debt to an old creditor, and because the loaned funds were "earmarked" to pay a particular creditor they never became part of the debtor's assets.

There are three general tests regarding earmarking. First, the "intent" test requires the following three elements for a transfer to fall within the earmarking doctrine: (1) there must be an agreement between the new creditor and the debtor that the funds provided to the debtor by the new creditor will be used to pay a specified debt to the old creditor; (2) the agreement must be performed according to its terms; and (3) the transaction viewed as a whole must not result in diminution of the estate. *See In re Bohlen Enter., Ltd.*, 859 F.2d 561, 566 (8th Cir. 1988).

Second, the "dominion/control" test looks at whether "the debtor exercised dominion or control over the transferred property." *Parks v. FIA Card Servs., N.A. (In re Marshall)*, 550 F.3d 1251, 1255 (10th Cir. 2008) (holding that the "Debtors' exercise of their ability to control the disposition of the loan proceeds is the essence of this case"). Third, the "diminution" test looks

[1] Materials prepared by Michael F. Thomson, Dorsey & Whitney LLP, 111 South Main Street, Suite 2100, Salt Lake City, Utah 84111. Thomson.michael@dorsey.com.

at whether the transfer of property "deprives the bankruptcy estate of resources which would otherwise have been used to satisfy the claims of creditors." *Id.* at 1255-56.

Currently, the Tenth Circuit Court of Appeals has not yet applied the earmarking doctrine beyond the co-debtor context. As explained in *Manchester v. First Bank & Trust Co. (In re Moses)*, 256 B.R. 641, 645-46 (10th Cir. BAP 2000), the earmarking doctrine "originally arose under the Bankruptcy Act in codebtor cases—the new creditor, who was obligated on an existing debt as a guarantor or surety, provided the debtor with funds to pay the old creditor." While the earmarking doctrine has since been extended by many courts to situations where the new creditor is not a guarantor or surety of the existing debt[2], the Tenth Circuit has not officially applied the doctrine as a defense. *See In re Marshall*, 550 F.3d at 1257 n.5 (declining to decide whether earmarking doctrine should be extended beyond codebtor context, but holding that even if the doctrine were extended it would not apply in that case).

However, courts in the Tenth Circuit nevertheless have looked at the "dominion/control" and "diminution" tests in the context of determining whether the property transferred was an interest of the debtor in property. *See id.* at 1255-57 (applying dominion/control and diminution tests to Section 547(b) inquiry, but not applying intent test as part of earmarking doctrine); *In re Moses*, 256 B.R. at *In re Wagenknecht*, 2019 Bankr. LEXIS 1739 (10th Cir. BAP 2019) (same). *See also In re Baldwin*, 514 B.R. 646, 656-57 (Bankr. D. Utah 2014) (applying dominion/control and diminution tests to property of the debtor inquiry, and declining to apply earmarking doctrine since property was not property of the debtor/547(b) element not met).

[2] *See Collins v. Greater Atl. Mortg. Corp. (In re Lazarus)*, 478 F.3d 12, 15 (1st Cir. 2007) (stating that "most circuits" have extended earmarking doctrine beyond codebtor situations).

Conduit Issues

Courts have developed the "conduit theory" over time in an effort to avoid the potential unfairness of the literal application of 11 U.S.C. § 550(a), thereby absolving from liability a party who was only "a mere conduit, an intermediary or conduit between the bankrupt and the creditor." *Carson v. Federal Reserve Bank*, 254 N.Y. 218, 172 N.E. 475, 482 (1930). Section 550(a) states that an avoided transfer can be recovered from "the initial transferee." 11 U.S.C. § 550(a)(1). Unlike an "immediate or mediate transferee" under Section 550(a)(2), which has statutory defenses regarding value, good faith, and without knowledge, an initial transferee is strictly liable for an avoided transfer. Because the Bankruptcy Code does not define "initial transferee," courts have developed tests to determine who is an initial transferee.

The "Dominion" Test

Most courts, including the 10th Circuit, apply the dominion test to determine whether a party is an initial transferee. The genesis for the dominion test is credited to *Bonded Financial Services, Inc. v. European American Bank*, 838 F.2d 890 (7th Cir. 1988), in which the Seventh Circuit stated that "the minimum requirement of status as a 'transferee' is dominion over the money or other asset, the right to put the money to one's own purposes." 838 F.2d at 893.

The 10th Circuit Court of Appeals adopted the *Bonded* court's definition of initial transferee in *Malloy v. Citizens Bank (In re First Sec. Mortgage Co.)*, 33 F.3d 42 (10th Cir. 1994), and referred to the test as a "dominion or control test." Later 10th Circuit decisions have likewise reaffirmed the *Bonded* test, calling it the "dominion and control test" and noting that "those who act as mere 'financial intermediaries' or 'couriers' are not initial transferees" and that "[t]he term 'transferee' must mean something different from 'possessor' or 'holder' or 'agent,' or

'anyone who touches the money'." *Rupp v. Markgraf*, 95 F.3d 936, 941 (10th Cir. 1996) (quoting *Bonded*). *See also Bailey v. Big Sky Motors (In re Ogden)*, 314 F.3d 1190, 1202 (10th Cir. 2002).

In so doing, the 10th Circuit has adopted a two-part test for determining whether a party is a "transferee" under Section 550: "In order to be a transferee of the debtor's funds, one must (1) actually receive the funds and (2) have full dominion and control over them for one's own account, as opposed to receiving them in trust or as agent for someone else." *Rupp*, 95 F.3d at 942; *Bailey*, 314 F.3d at 1204. Notably, "full dominion and control" means "legal" dominion and control, such that the recipient was "free to invest the funds in lottery tickets or uranium stocks or any other endeavor." *Id.* at 1204-04 (quoting *Bonded*). In other words, mere physical control over the property is insufficient.

The "Control" Test

The 11th Circuit Court of Appeals had adopted a similar, yet distinct, test for determining whether a party is an initial transferee under Section 550—the "control" test. The inquiry under this test is more broad than the dominion test: "the control test is a very flexible, pragmatic one; courts must look beyond the particular transfers in question to the entire circumstances of the transaction." *Martinez v. Hutton (In re Harwell)*, 628 F.3d 1312, 1322 (11th Cir. 2010) (quoting *Norberg v. Societe Generale (In re Chase & Sanborn Corp.)*, 848 F.2d 1196 (11th Cir. 1988), *Andreini & Co. v. Pony Express Delivery Services, Inc. (In re Pony Express Delivery Services, Inc.)*, 440 F.3d 1296 (11th Cir. 2006).

Beginning with *Harwell*, the 11th Circuit's "control" test requires an affirmative showing of good faith by the transferee to escape initial transferee liability:

> Consistent with our precedent, we conclude that good faith is a requirement under this Circuit's mere conduit or control test. Accordingly, initial recipients of the debtor's fraudulently-transferred funds who seek to take advantage of equitable exceptions to § 550(a)(1)'s statutory language must establish (1) that they did not have control over the assets received, i.e., that they merely served as a conduit for the assets that were under the actual control of the debtor-transferor <u>and</u> (2) that they acted in good faith and as an innocent participant in the fraudulent transfer.

628 F.3d at 1323 (emphasis in original). At least one bankruptcy court within the 10th Circuit has declined to apply the *Harwell* good faith prong to the 10th Circuit's dominion test. *See Redmond v. NCMIC Fin. Corp. (In re Brooke Corp.)*, 568 B.R. 378, 420-21 (Bankr. D. Kan. 2017). *See also Timothy v. Pia, Anderson, Dorius, Reynard & Moss LLC*, 424 P.3d 937, 945-46 (Utah App. 2018) (vacated on mootness grounds).

<u>SBRA of 2019 – Due Diligence Amendment to Section 547(b)</u>

The Small Business Reorganization Act of 2019 ("<u>SBRA</u>"), which becomes effective in February 2020, amended Section 547(b) as follows (new language underlined):

> (b) Except as provided for in subsections (c) and (i) of this section, the trustee may<u>, based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses under subsection (c),</u> avoid any transfer of an interest of the debtor in property—

Thus, before a preference action plaintiff (DIP or trustee) can avoid a transfer as a preference, it must (i) conduct "reasonable due diligence" and (ii) take into account a potential defendant's known or "reasonably knowable" statutory defenses under 547(c). This new language codifies a plaintiff's duty to consider a defendant's likely subsection (c) defenses before filing a complaint, and will hopefully end the days of plaintiffs shooting first and asking questions later.

Avoidance Powers Update
ABI
Rocky Mountains
Ron Peterson
January 23 and 24, 2020

I. Preferences

On August 23, 2019, President Trump signed into law Public Law 116-54. While this law deals primarily with the new subchapter 5 of Chapter 11, applicable to small businesses, it does have two important impacts on preferences.

A. To Sue the Check Book?

In the last ten years, we have seen a rise in preference mills—virtual and contingent fee law firms that sue to recover every transfer the debtor made within 90 days, whether there is an affirmative defense or not. Often, the preference plaintiff would bring her adversary actions hours before the §546(a) deadline approached. Bankruptcy Judge McEwan (M.D. Fl. Tampa Division) refers to this technique as "suing the check book."

The ABI's Chapter 11 reform commission appointed me to chair the avoidance power committee. The question of suing the check book was a bothersome issue. We ultimately decided that there must be some relief from this wasteful practice including requiring the trustee or debtor to perform pre-suit work to ferret out affirmative defenses in advance. However, we are also mindful that there is a key difference between the due diligence a solo practitioner trustee can do from her basement, and the due diligence a well-heeled trustee and his forensic accountant can do. Therefore, there must be a flexible approach.

The new act amends §547(b) by inserting the following qualification: **"based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defense under the subsection (c) apply."**

The amendment leaves courts discretion to fill numerous blanks. Must a trustee or debtor affirmatively plead compliance? What if the trustee or debtor simply sues the check book—are they subject to sanctions or a reduction of fees? How does this provision interplay with Fed. R. Bankr. P. 9011? This amendment should not be something new. The Court of Appeals for the Seventh Circuit, in *In re Excello Press, Inc.*, 987 F.2d 1109 (7th Cir. 1992), long ago imposed on avoidance plaintiffs the duty to ferret out affirmative defenses.

What can the litigant do? A very good practice customary in many districts is for the trustee or debtor to send a demand letter, ideally around six months before the deadline under §546. The target should then respond with a letter detailing her affirmative defenses. This approach has three major advantages. First, it starts the running of pre-judgment interest. Second, it provides an absolute defense to a Rule 9011 sanction or violation of the spirit of the amendment if the defendant ignores the demand letter or doesn't raise the defenses. Finally, it is the gateway to self-mediation of the dispute without litigation.

In addition, when I start a preference campaign, I ask the accountant to perform two tests. First, the accountant should look at the claims docket and proofs of claim and try to determine whether my targets provided goods or services to the debtor for which they were not paid. Second, I ask the accountant to determine the mean, median, and mode for each of the target's payments. I then want to know which payments fell more than 15 day past the mean, median, or mode as the case may be.

B. **Venue: New Floor, Same Uncertainty.**

"Those who fail to learn from history are condemned to repeat it."
-Winston Church in a speech to parliament in 1948

The second change is more interesting. In the 2005 BAPCPA amendments, Congress revised 28 U.S.C. § 1409(b) to place floors on certain bankruptcy litigation in which venue is based

on the case's status as an "action arising in or related to" a pending bankruptcy case. Mysteriously, the amendments did not deal with actions arising under title 11. If the action was for an amount of money less than the floor, it had to be brought in the defendant's home court rather than the debtor's home court.

The new law amends the venue statute, 28 U.S C. § 1409(b), to raise the floor amount for non-insider commercial claims from $10,000 to $25,000. However, history repeats itself. Despite the recommendation of the ABI commission to the contrary, actions "arising under title 11" are not covered by the floor.

The venue statute's language closely follows the definition of jurisdiction under 28 U.S.C § 1334. Under that section, the case law suggests that avoidance actions arise under title 11. The only reported case I could find in the Tenth Circuit, *Redmond v. Gulf City Body &Trailer Works, Inc.*, 454 B.R. 166 (Bankr. D. Kan. 2011), supports this conclusion. There is not unanimous agreement on this point, however. Some courts have bent over backwards to foster Congress' intent to reign in small preference actions, in spite of the language of the statute.

C. *Subsequent Advance of Credit; Must It Remain Unpaid?*

Section 60(c) of the act of 1898 was the earlier incarnation of the subsequent advance of credit defense. One requirement of the section was that the subsequent advance of credit had to remain unpaid. If that advance remained unpaid, the defendant was entitled to a dollar-for-dollar credit against the trustee's case. Did the bankruptcy code of 1978 change that time-honored rule? After all, Congress does not write on a blank slate.

In December 2015 the Court of Appeals for the Seventh Circuit answered that question in in the negative in *Sparrer Sausage Co. v. Jason's Food*s, *Inc.*, 826 F.3d 388 (7th Cir. 2015). The Court based its ruling on an earlier precedent in *In re Prescott*, 805 F.2d 719 (7th Cir. 1986).

However, neither decision involved the situation where the defendant received payments on its subsequent advance of credit. The Court merely restated the rule as if 60(c) had never been repealed by Congress.

However, in *Kaye v. Blue Bell Creameries, In.*, 899 F.3d 1178 (11th Cir. 2018), the Court of Appeals for the Eleventh Circuit distinguished its earlier holding in *Charisma Investment Company, N. V. Airport System, Inc.*, 841 F.2d 1082 (11th Cir. 1988), as mere *dictum.* The Court first looked at section 60(c) of the act of 1898, which made it very clear that if the subsequent advance of credit was repaid, no defense was possible. However, the court next held that 11 US.C. § 547(c)(4) repealed this provision. Instead, the unpaid language was replaced with "if the creditor received a payment that was not unavoidable, then that creditor was entitled to a defense. The court and most people who read this section are confused by the double negative "did not make an unavoidable transfer". If we drop the double negative, then the section would read, "the creditor made an avoidable transfer" which entitles the creditor to the defense and the trustee must give a credit to the creditor. The court concluded that 11 U.S.C. § 547(c) was a substantial departure from section 60(c) of the act of 1898.

As a policy matter, the court also felt that not requiring the future advance of credit to remain unpaid would encourage the policy announced by the bill's sponsor, congressman Edwards of California, which was to encourage creditors to work with distressed debtors and not upset normal creditor/debtor relationships.

The court also looked at simple economics. Let us assume the debtor made a preferential payment to the creditor of $100. The estate is depleted by $100. Subsequently, the creditor ships new goods worth $40. The estate is now depleted by a net of $60. If that creditor received a voidable transfer, the trustee could sue the creditor for the original $100 and the $40, but give a

credit of $40, leaving the net law suit at $100. If we adopted the rule that the creditor is not entitled to the defense when he is paid the $40, then the trustee can sue for $140 even though the estate only had an economic depletion of $100. This results in a $40 windfall for the trustee.

Across the country, the "remained unpaid" rule has done well. The Courts of Appeals for the Fourth, Fifth, Eighth, and Ninth Circuits have held that the creditor is entitled to the defense if the subsequent payment was avoidable. *Hail v. Chrysler Credit Corp*. 412 F.3d 545 (4th Cir. 2005); Lake vs. 14 F.3d 1088 (5th Cir. 1994); *Jones Truck Line, LLC vs. Cent. States, se. and sw. Areas Pension Fund* 130 F.3d 323 (8th Cir. 1997); *Mosier v. Ever-Fresh Food Co*. 52 F.3d 229 (9th Cir. 1995). In the Third Circuit, there is dictum to the same effect in *New York City Shoes v. Bentley International, Inc*., 880 F.2d 679 (3rd Cir. 1989). No other court has followed the Seventh Circuit's holding in *Unsecured Creditors Committee of Sparrer Sausage Company v. Jason's Foods Inc.*, 826 F.3d 388 (7th Cir. 2016). However, there is no circuit-level precedent in the First, Second, Tenth, or D.C. Circuits. It is my conclusion that the Tenth Circuit will follow the majority rule.

II. Fraudulent Transfers

A. Extraterritoriality: Strangers in a Strange Land

On February 25, 2019, the Court of Appeals for the Second Circuit decided *In re Picard*, 917 F.3d 85 (2d. Cir. 2019). This case consolidated 88 appeals from the decision of the bankruptcy court which dismissed the trustee's actions on the ground that the trustee could not exercise his domestic avoidance powers in foreign states. The trustee, Irving Picard, brought hundreds avoidance actions against Bernard Madoff's feeder funds. However, many of these feeder funds transferred the money from Madoff to their respective foreign investors. These investors were citizens of foreign states and were subsequent transferees. Madoff Securities was a master fund.

It received money from feeder funds. The feeder funds received money from the next tier of investors. When those investors wanted their money back, they would make a demand on the feeder fund and the feeder fund would make an identical demand on the master fund, Madoff. To make matters more complicated, some of these feeder funds were themselves in foreign insolvency proceedings.

The legal issue in *Picard* is the canon against extraterritoriality. This canon provides that absent clearly expressed Congressional intent to the contrary, federal laws will be construed to have only domestic application. The canon helps avoid the international discord that can result when U.S. law is applied to conduct in foreign countries by foreign nationals. It also reflects the commonsense notion that Congress generally legislates with domestic concerns in mind. An action may proceed if either the statute indicates its extraterritorial reach or the case involves a domestic application the statute.

If the initial transferee was a foreign entity, extraterritoriality would not be an issue since the focus of the statute is on the conduct of the transferor, not the location of the transferee. However, what happens when the initial transferee transfers the funds subject to avoidance to another foreign entity? The appellate court examined comity in two ways. First, the canon of construction might shorten the statute. This application is called prescriptive comity and asks the question of statutory interpretation: should a court presume that Congress, out of respect for foreign sovereigns, limited the application of domestic law on a given set of facts? The second application, known as adjudicative comity, asks whether, where a statute might otherwise apply, a court should nonetheless abstain from exercising jurisdiction in deference to a foreign nation's courts that might be a more appropriate forum for adjudicating the matter.

The Court of Appeals found that the focus of §550 is the critical section. Its focus is on where the transfer took place, not who received it. If the transfer took place from a domestic debtor, than the court held that any subsequent transfer is governed by the domestic statute. The court further found that the trustee should not be compelled to travel around the world filing ancillary proceedings in foreign courts. As for the subsequent transferee, the court noted that the subsequent transferee knew exactly from where the money was coming and should have anticipated that U.S. law would apply.

The Appellees have filed a petition for a writ of *certiorari*. On December 9, 2019, the Supreme Court asked the Solicitor General to weight in. If the Solicitor General thinks international relations is an important consideration, it may ask the Supreme Court to grant the writ.

B. College Clawbacks: Win One for the Gipper?

On November 12, 2019, the Court of Appeals for the First Circuit avoided a transfer of a parent's payment of an adult child's tuition to her school. *DeGiacoma v. Sacred Heart University, Inc.*, 942 F.3d 55 (1st Cir. 2019). In doing so, *DeGiacoma* became the first circuit-level decision regarding this contentious issue. The facts are terrible. The parents, Mr. and Mrs. Palladino, were convicted of running a multi-million dollar Ponzi scheme, and spent over $64,000 of the fraudulent proceeds to provide their adult child with a great college education. This decision is straight forward. The creditors of the Ponzi operators received no benefit from having $64,000 of their money spent at Sacred Heart. The Palladinos were hopelessly insolvent at the time they paid the tuition.

Attached as Exhibit A is a summary of cases collected by Atlanta trustee Neil Gordon. The trustee is winning some of these cases, but losing others. There seems to be three standard

defenses. First, the parents do receive value when they pay their child's tuition because it prevents the child from remaining a drone and dependent of the parents and provides the parents some assurance that someone will look after them when they retire. Second, at least one court has held that it is the student, not the university that is the initial transferee. Finally, other courts have held that the family is a unit and that the unit receives benefits when the tuition bills paid.

There are several anomalies in these cases. First, if the student is lucky enough have divorced parents, the divorce decree or court-approved separation agreement may require the parents to pay for the college education. Why should children of divorced parents be treated better than children of happily married parents? Second, would the court have reached the same result if the child was a prodigy, 16 or 17 when she entered college? Are tuition payments to a private high school immune from avoidance? Will colleges and universities simply react by requiring the student to send in the tuition check rather than the parents? Finally we should not lose sight that the experts have predicted that at least 25% of our private, not-for-profit schools will not be here in 2030. Allowing tuition claw backs would be nothing more than an additional nail in the coffin for these struggling schools.

***In re Wierzbicki*, 830 F.3d 683 (7th Cir. 2016)**

Intangible, non-economic benefits do not count as reasonably equivalent value in defense of a fraudulent transfer action

Wierzbicki

- While insolvent, debtor transfers (for $1 by QC deed) 40-acre farm in Wisconsin with $151K of equity
- Chapter 7 fourteen months later
- Trustee sues to avoid transfer
- Only issue in dispute: was reasonably equivalent value exchanged for the transfer?
- Purported consideration was stopping transferees endless litigation and appeals

Wierzbicki

- Bankruptcy court – the “meritless appeals” had no value
- Circuit Court agrees. Giving up the farm to eliminate the risk of losing the farm made little sense in terms of value
- Circuit Court rejects transferee argument that available homestead exemptions eliminated the equity – not even relevant (nor is D even allowed an exemption in voluntarily transferred property)

Wierzbicki

- Avoiding further family conflict too "nebulous" in a bankruptcy context, where the transfer put the debtor's property beyond the reach of creditors
- Creditors would be unwilling to volunteer to provide a financial subsidy to enhance the insolvent debtor's family relationships by allowing the debtor to put valuable property beyond their reach

- Standard §548 defenses/issues apply such as **solvency**
- Real fight is over **reasonably equivalent value**
- Courts are divided on whether there is **reasonably equivalent value** in paying an adult child's college tuition

Isn't this just an intangible "nebulous," speculative benefit?

Look at §548(d)(2) where "value" is defined as "property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor." (emphasis added)

Is there reasonably equivalent value?

YES: *DeGiacomo V. Sacred Heart Univ.* ***(In re Palladino)****,* 556 B.R. 10 (Bankr. D.Mass. 2016) (Hoffman, J.) (financially self-sufficient daughter provides an economic benefit)

NO: *Roach v. Skidmore College* ***(In re Dunston)****,* 566 B.R. 624 (Bankr. S.D.Ga. 2017) (Coleman, J.) (no economic benefit conferred)

Dunston

Reasonably Equivalent Value

- Any moral obligation to pay for college and help daughter achieve financial independence did not:
  - (i) provide an "economic" benefit to D,
  - (ii) satisfy any legal duty or obligation to pay, and
  - (iii) increase D's assets in any way that could be used to pay her creditors

Knight

NO: *Boscarino v. Board of Trustees of Conn. State Univ. System* ***(In re Knight)*** 2017 WL 4410455 (Bankr. D.Conn. 9/29/17) (Tancredi, J.) (Conferred no value to D within meaning of §548(d)(2)(A). Expectation of future economic benefit is too speculative)

Knight

- Only issue is whether reasonably equivalent value was received in exchange for paying adult son's tuition
- Debtor: enable son to move out of home and to achieve financial independence
- University: "value" received was discharge of familial obligation to pay tuition and expenses

Knight

Court rejects:
"While such support is unquestionably admirable, it may have helped to fulfill her Expected Family Contribution under the federal financial aid regime, it is undisputed that the debtor had no legal obligation to pay for her adult son's college education. The transfers did not, therefore, satisfy 'a present or antecedent debt of the debtor' or otherwise confer 'value' to the debtor within the meaning of 11 U.S.C. §548(d)(2)(A)." (emphasis added)

13677142 not if, but how.

NO: ***Geltzer v. Oberlin College, et al (In re Sterman)***, WL 6333588 (Bankr. S.D.N.Y. Dec. 4, 2018) (Glenn, J.) (the purported economic "benefit" did not constitute "value" under either the B.Code or N.Y. law)

- This "is a culturally and socially charged issue."
- Increasing likelihood of that children would be self-sufficient was not value under the B.Code or N.Y. law.

13677142 12 not if, but how.

Geltzer

- Moral obligation to pay is insufficient where there is no legal obligation
- Constructively fraudulent transfers that are recovereable only if made after children are legally adults (age 21 under N.Y. law) because parents requird to support a non-adult child

In addition to the standard defenses, there are unique defenses to attempted clawbacks of tuition payments.

(A) POE (§529 Plans)

- 541(b)(6): POE excludes "funds … contributed to an account in accordance with §529(b)(1)(A) of the Internal Revenue Code … not later than 365 days before the [PD] …."
- Must be able to adequately trace funds to D's 529 plans
- May need evidence of D's other income and expenses during relevant time periods

(B) Fed'l Direct Parent PLUS Loans ("FDPPL")

- Governed by Higher Education Act of 1965 (20 USC §1001 *et seq.;* 34 C.F.R. 685.100 *et seq.*)
- Parent can borrow to pay for tuition and other qualified educational expenses
- All loans are disbursed by either electronic transfer of funds directly from the lender to the eligible institution or
- a check co-payable to the eligible institution and the student or parent borrower

Novak v. Univ. of Miami (In re Demitrus), 586 B.R. 88 (Bankr. D.Conn. 2018) (Tancredi, J.)

In re Demauro, 586 B.R. 379 (Bankr. D.Conn.2018) (Nevins, J.) (same)

- Univ. receives transfers via FDPPL for adult child's tuition
- T sues to recover $66,616
- Univ. moves to dismiss
- Motion granted. Transferred funds did not constitute an interest of the D in property

Demitrus

- Funds could never have been considered D's property
- Funds never within the reach of creditors
- No diminishment of D's bankruptcy estate
- Earmarked from lender to university

Neil's Comments

- T could have successfully attacked this differently:
- T should have sought to avoid the obligation itself as fraudulently incurred because D likely did not receive reas. equiv. value for incurring the obligation
- Then sue to recover the loan repayments made by D to the lender
- T still would have no claim v. the university

(C) University as Mere Commercial Conduit

***In re Adamo,* 582 B.R. 267 (Bankr. E.D.N.Y. 2018) (Craig, C.J.)**

- T sues Hofstra Univ., Fairfield Univ. & Brooklyn Law School for approximately $278K total
- All 3 schools treated the funds similarly

Adamo

- School accounts are created by the student with a unique user name and password
- Funds are placed in the account through an electronic portal and transferred to univ. general account only upon student's registration for classes
- After D transfers the funds to those accounts, D cannot access the accounts absent account holder's authorization. Nor can the schools utilize the funds
- If student withdraws from the programs, the student receives the refund of the account balance
- Any payments credited to student's account are considered credits belonging to the student and not to any third party – such as D.

13677142 21 not if, but how.

Adamo

- Ct. rules schools did not exercise dominion and control over the tuition payments
- Schools were mere commercial conduits
- Schools only gained dominion and control after student registered for classes that semester, whereupon funds would be applied to tuition
- If student withdrew, student would receive the funds and been under no obligation to return funds to D

13677142 22 not if, but how.

Adamo

- Ct. equates the student portals to a bank account with the children/students as the initial transferees and the school as subsequent transferee
- Schools are then protected by asserting the good faith defense under §550(b) as value was given for the subsequent transfers to the school
- *Bonded Finan. Svcs., Inc. v. European Amer. Bank*, 838 F.2d 890 (7th Cir. 1988) is "exactly on point." No different than a bank.
- The school's electronic system was merely holding the funds for the student account holders. The schools/transferees were mere conduits.

13677142 23 not if, but how.

Adamo

District Court vacates and remands

2018 WL 6182502 (E.D. N.Y. Nov. 27, 2018) (Ross, J.)

Amended 595 B.R. 6 (E.D.N.Y. 2019)

- B.Ct. failed to address a key factual question
- Transferee must lack dominion over the funds and not be able to use them for its own purposes to be a "mere conduit"
- A "mere conduit" is no more than a transmitter of the transfer

13677142 24 not if, but how.

Adamo

- Here, tuition was not owed until a student had affirmatively registered for classes for the upcoming term
- If students withdrew without registering they would receive a refund of any prepaid tuition in their student accounts
- Payments made while D's children were still eligible for a refund had to be treated differently from payments that children could not collect
- D.Ct. amends on motion for reconsideration to clarify that the court was not making a finding as to when a tuition pament would be refundable or not.