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**New Wave of Litigation – Fraudulent Transfers,
Broken Commitments,
Failure to Fund and Lack of Good Faith**

FRAUDULENT TRANSFER ISSUES

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I. Fraudulent Transfer Overview

A. Introduction

Fraudulent conveyances or transfers are governed by two sets of laws that are generally consistent. The first is the Uniform Fraudulent Transfer Act ("UFTA") that has been adopted by all but a handful of the states. The second is found in the federal Bankruptcy Code.

There are two kinds of fraudulent transfer. The archetypal example is the intentional fraudulent transfer. This is a transfer of property made by a debtor with intent to defraud, hinder, or delay his or her creditors. The second is a constructive fraudulent transfer. Generally, this occurs when a debtor transfers property without receiving "reasonably equivalent value" in exchange for the transfer if the debtor is insolvent at the time of the transfer or becomes insolvent or is left with unreasonably small capital to continue in business as a result of the transfer. Unlike the intentional fraudulent transfer, no intention to defraud is necessary.

The Bankruptcy Code authorizes a bankruptcy trustee to recover the property transferred fraudulently for the benefit of all of the creditors of the debtor if the transfer took place within the relevant time frame.¹ The transfer may also be recovered by a bankruptcy trustee under the UFTA too, if the state in which the transfer took place has adopted it and the transfer took place within its relevant time period.²

B. Statutory Scheme

Section 544 promotes the central bankruptcy policy of equitable distribution among all creditors.³ Further, Section 544 advances the goal that a debtor's prepetition transfers should not deprive creditors of property from which their claims can be satisfied.⁴

Section 544 provides, in relevant part:

(b)(1) ... the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title.

¹ Within two years prior to the filing of bankruptcy - 11 U.S.C.A. § 548(a).

² 11 USC § 544(b) allows trustees to employ applicable state law to recover fraudulent transfers. The time period under the UFTA is in most cases four years before action is brought to recover. - UFTA § 9.

³ See *In re Giordano*, 188 B.R. 84, 88 (D.R.I.1995); *In re 375 Park Avenue Assocs., Inc.*, 182 B.R. 690, 695 (Bankr.S.D.N.Y.1995).

⁴ *In re Stoecker*, 131 B.R. 979, 984 (Bankr.N.D.Ill.1991) (citing H.Rep. No. 595, 95th Cong., 1st Sess. 375 (1977); S.Rep. No. 989, 95th Cong., 2d Sess. 89-90 (1978), reprinted in 1978 U.S.C.C.A.N. 5787).

Section 544 incorporates the UFTA, which provides, in relevant part:

A transfer made or an obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation as follows:

* * *

(b) without receiving reasonably equivalent value in exchange for the transfer or obligation, and the debtor:

(1) was engaged or was about to engage in a business or transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

(2) intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due.

The UFTA, which has been adopted by 43 states and the District of Columbia and is the successor to the Uniform Fraudulent Conveyance Act (“UFCA”), resembles the provisions of 11 U.S.C. § 548 more closely than did the UFCA.⁵

In a fraudulent transfer action brought under §548 of the Bankruptcy Code, the debtor-in-possession or trustee has two goals. The first goal is to avoid a transfer, the effect of which is either to place putative property of the estate beyond the reach of the general body of creditors, or to burden the estate with an obligation, such as a mortgage or security agreement that stands in the way of a meaningful distribution to unsecured creditors. The second goal is to utilize §550 of the Code to recover the value of property for creditors or rid the estate of the obligation incurred, thereby enhancing the value of the estate's existing property.⁶

Section 548 provides, in relevant part:

(a) (1) The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—
(A) made such transfer or incurred such obligation with actual intent to hinder, delay or defraud any entity to which the debtor was or became, on

⁵ *Collier on Bankruptcy* ¶ 548.01[3], p. 548-8 (15th ed.1979).

⁶ Howard Gorney and Lee Harrington. “The Importance of Good Faith in Fraudulent Transfer Analysis,” American Bankruptcy Institute, March 1, 2003.

or after the date that such transfer was made or such obligation was incurred, indebted; or
(B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
(ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
(II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or
(III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or
(IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

Section 550 provides, in relevant part:

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

C. Defenses

Like many sections in the Code, §548(c) also provides an exception to the trustee's avoidance power that shapes the analytical framework of fraudulent transfer actions in bankruptcy:

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

Likewise, §550(b) provides safe harbor for a good-faith immediate or mediate transferee of the initial transferee, as follows:

(b) The trustee may not recover under section (a)(2) of this section from—

- (1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or
- (2) any immediate or mediate good faith transferee of such transferee.

Section 550(b) was specifically tailored to prevent an initial transferee from whom a trustee could recover under §550(a)(1) from "washing" the transaction through to a subsequent transferee who might be acting in concert. This technique is forestalled by requiring that the subsequent transferee also act in good faith.⁷ It has been held that good faith requires an arm's length transaction,⁸ as well as the following three factors: (i) an honest belief in the propriety of the activities in question; (ii) no intent to take unconscionable advantage of others; and (iii) no intent to, or knowledge of the fact that the activities in question will hinder, delay, or defraud others.⁹

II. Fraudulent Transfer Hypotheticals

A. Corporate Payments for Principal's Personal Expenses

1. Issue

A small business corporation pays the personal expenses of its principal. The corporation files for chapter 7 bankruptcy relief and the trustee sues all of the principal's creditors to avoid the payments made by the corporation to each of them during the one, four or six year prepetition period, including credit cards, utilities, car payments, etc. What defenses do these unsuspecting creditors have? Can they show that the corporation's payments to them were really the principal's compensation?

2. Rule

Fraudulent corporate conduct can give rise to different civil legal consequences. When corporate assets are transferred, fraudulent conveyance law can be invoked to recover the assets from the transferees.¹⁰ Available to trustees and debtors-in-possession are both 11 U.S.C. §548 and, through section 544(b), state fraudulent conveyance law.¹¹

⁷ See, e.g., *In re Commercial Acceptance Corp.*, 1993 U.S. App. LEXIS 23158 (9th Cir. 1993).

⁸ *Bullard v. Aluminum Co. of Am.*, 468 F.2d 11, 13 (7th Cir. 1972).

⁹ *Southern Indus., Inc. v. Jeremias*, 411 N.Y.S.2d 945, 949 (2d Dep't 1978).

¹⁰ See 11 U.S.C. §§ 548, 550(a); Unif. Fraudulent Transfer Act §§ 4, 5, 7, 7A U.L.A. 652–53, 657, 660 (defining what constitutes fraudulent transfers); *In re Lifschultz Fast Freight*, 132 F.3d 339, 354 (7th Cir. 1997) (observing bankruptcy law's preference and fraudulent transfer provisions empower "trustees with potent tools to avoid insiders' last-minute attempts to strip a debtor of capital").

¹¹ William T. Vukowich, *Civil Remedies in Bankruptcy for Corporate Fraud*, Am. Bankr. Inst. L. Rev. Vol. 6, no. 2 (winter 1998).

In many cases, corporate owners brazenly transfer corporate assets for their own personal benefit.¹² Transfers of corporate funds to pay owners' debts,¹³ transfers to purchase assets for an owner's other businesses,¹⁴ transfers for no consideration to reduce related companies' debts,¹⁵ transfers to third parties who in turn provide insiders with significant gains,¹⁶ and cash transfers directly to owners for no legitimate business purpose¹⁷ are examples of rather obvious fraudulent transfers. In all of these examples, the corporate debtor receives nothing in consideration for the transfers of corporate assets. Rather clearly, these facts justify a finding that the transfers were made with an intent to defraud the corporations' creditors.¹⁸ Indeed, both the common law's traditional "badges of fraud"¹⁹ and the UFTA²⁰ indicate that the main characteristics of these kinds of transfers – to or for the benefit of corporate insiders, for no consideration and when the

¹² See, e.g., *In re Acequia, Inc.*, 34 F.3d 800, 806 (9th Cir. 1994) ("no documentation, other than ambiguous check memo–line notes, to confirm [insider's] 'innocent' explanations for the transactions"); *Max Sugarman Funeral Home, Inc. v. A.D.B. Investors*, 926 F.2d 1248, 1253, 1255 (1st Cir. 1991) (transfers from corporation "a sham," for "no legitimate . . . purpose"); *Lunsford v. Haynie*, 175 F.2d 603, 606 (5th Cir. 1949) ("bare faced and inexcusable appropriation to [shareholder's] own personal use"); *Bartle v. Markson*, 299 F. Supp. 958, 963–64 (N.D.N.Y. 1969) ("overall plan . . . to transfer assets of the corporation . . . causing [its] assets . . . to be depleted").

¹³ See *In re Video Depot, Ltd.*, 127 F.3d 1195, 1196 (9th Cir. 1997) (payment of owner's gambling debt to casino); *Rupp v. Markgraf*, 95 F.3d 936, 941 (10th Cir. 1996) (payment in partial satisfaction of owner's personal liability on judgment).

¹⁴ See *Stoebner v. Lingenfelter*, 115 F.3d 576, 578 (8th Cir. 1997) (debtor–corporation's assets used to purchase rare documents for another of owner's corporations).

¹⁵ See *In re FBN Food Servs., Inc.*, 82 F.3d 1387, 1393 (7th Cir. 1996) (holding claim settlement owed to debtor transferred for benefit of related company); see also *In re Southeast Hotel Properties Ltd. Partnership*, 99 F.3d 151, 152 (4th Cir. 1996) (stating debtor corporation's post–bankruptcy payments of controlling corporation's bills recoverable).

¹⁶ See *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 786 (Del. Ch. 1992) (insider received favorable business deals from third parties after insider caused debtor–corporation to surrender valuable rights against third parties).

¹⁷ See *Acequia*, 34 F.3d at 803 (corporate funds transferred to owner and "used for personal expenses").

¹⁸ See 11 U.S.C. § 548(a)(1)(A); Unif. Fraudulent Transfer Act § 4(a)(1), 7A U.L.A. 652; *Stoebner*, 115 F.3d at 576 (holding of actual fraudulent intent based upon jury's special verdict); *Acequia*, 34 F.3d at 800; *In re EMB Assocs., Inc.*, 100 B.R. 629 (Bankr. D. R.I. 1989) (relying in part on "badges of fraud"); *Max Sugarman Funeral Home*, 926 F.2d at 1254.

¹⁹ See *Acequia*, 34 F.3d at 806 (observing that debtor–corporation's bankruptcy was "imminent," "lawsuits were pending," recipient of transfers "maintained total control over the corporation's finances"); *Max Sugarman Funeral Home*, 926 F.2d at 1248 (citing "insolvency or other unmanageable indebtedness," "special relationship between the debtor and the transferee"); *EMB Assocs.*, 100 B.R. at 633 (listing transfer of all assets of value, in contemplation of bankruptcy, while insolvent, and not in ordinary course).

²⁰ See Unif. Fraudulent Transfer Act §§ 4(b)(1) (8), (9), 7A U.L.A. 653 (providing that transfer to "insider," relative "value of consideration" received by debtor for transfer, and debtor's solvency all relevant to finding of "actual intent" to defraud); *Taylor v. Rupp* (*In re Taylor*), 133 F.3d 1336, 1338 (10th Cir. 1998) (stating that UFTA includes nonexclusive list of badges of fraud that may be considered as evidence of debtors' fraudulent intent).

corporation is insolvent – justify the inference that the transfers were made with fraudulent intent.

Even when actual intent cannot be established, a transfer for less than a "reasonably equivalent value"²¹ can nevertheless be set aside if the corporation is "insolvent,"²² if the corporate property remaining after the transfer represents "an unreasonably small capital,"²³ or if the corporation is likely to incur debts that it will not be able to repay.²⁴ If a fraudulent transfer is established, the trustee may recover the property transferred from "initial transferees"²⁵ regardless of their good faith.²⁶ Recovery is denied against subsequent transferees who take for value, in good faith, and without knowledge of the voidability of the transfer.²⁷

3. Compensation

Because the cases for voidability are strongest when transfers are for no or less than fair consideration, transfers to corporate owners are often disguised as routine and proper business transactions. Transfers are commonly alleged to be justified as part of the salary or bonus for an insider's services or in redemption of stock owned by an insider.

²¹ Unif. Fraudulent Transfer Act § 5(a), 7A U.L.A. 657; 11 U.S.C. § 548(a)(1)(B). See, e.g., *In re Image Worldwide Ltd.*, 139 F.3d 574, 581 (7th Cir. 1998) (holding that debtor–corporation did not receive reasonably equivalent indirect benefits in guaranteeing loan to affiliate); *In re Dunham*, 110 F.3d 286, 286 (5th Cir. 1997) (holding that business assets' appraised value of \$200,000 clearly not reasonably equivalent to approximately \$40,000 paid to debtor–corporation); *Scholes v. Lehman*, 56 F.3d 750, 756–58 (7th Cir. 1995) (explaining that payments to Ponzi investor not reasonably equivalent to extent they exceed his investment).

²² Unif. Fraudulent Transfer Act § 5(a), 7A U.L.A. 657; 11 U.S.C. § 548(a)(1)(B)(i). See, e.g., *In re Joshua Slocum, Ltd.*, 103 B.R. 610, 620–24 (Bankr. E.D. Pa. 1989) (analyzing, in detail, whether transfer rendered debtor–corporation insolvent).

²³ 11 U.S.C. § 548(a)(1)(B)(ii)(II); Unif. Fraudulent Transfer Act § 4(a)(2)(i), 7A U.L.A. 653. See *In re Lifschultz Fast Freight*, 132 F.3d 339, 343 (7th Cir. 1997); *Stoebner v. Lingenfelter*, 115 F.3d 576, 576 (8th Cir. 1997); *Joshua Slocum*, 103 B.R. at 625.

²⁴ See 11 U.S.C. § 548(a)(1)(B)(ii)(III); Unif. Fraudulent Transfer Act § 4(a)(2)(ii) 7A U.L.A. 653.

²⁵ 11 U.S.C. § 550(a)(1). Courts of Appeals generally hold that an initial transferee must, at a minimum, have dominion and control over the property transferred, including the right to use the property for the transferee's own purposes. See *In re Video Depot, Ltd.*, 127 F.3d 1195, 1198–1200 (9th Cir. 1997); *In re Southeast Hotel Properties Ltd. Partnership*, 99 F.3d 151, 154–55 (4th Cir. 1996); *Rupp v. Markgraf*, 95 F.3d 936, 938–41 (10th Cir. 1996).

²⁶ See *Southeast Hotel Properties*, 99 F.3d at 157; *Rupp*, 95 F.3d at 938, 944 (stating that Congress has balanced equitable considerations under § 550 by setting strict liability standard for initial transferees and non–strict liability standard for subsequent transferees). In some cases, the initial transferees are arguably "in the best position to monitor fraudulent transfers from the debtor." *Id.* at 938, 944 (initial transferees received check paid for by debtor–corporation in payment of debt owed to transferees by insider).

²⁷ See 11 U.S.C. § 550(b)(1); *Max Sugarman Funeral Home*, 926 F.2d at 1256–57, n.14 (finding transferee neither good faith transferee nor was it without knowledge of voidability of transfer under Code). One is also protected if he took from one who gave value, in good faith, and without knowledge of the voidability of the transfer. See 11 U.S.C. § 550(b)(2).

Paying a corporate owner a salary that exceeds the value of his services is, of course, one way to attempt to disguise an improper transfer of corporate assets to the principal.²⁸ The amount by which compensation exceeds the reasonable value of the services should be recoverable under fraudulent conveyance theory. Reasonably equivalent value criteria demands that "salaries of officers in an efficiently managed corporation must bear a reasonable relation not only to the services rendered but to the income of the business, both gross and net."²⁹ Compensation must be in proportion to ability, services rendered and time devoted to the corporation's affairs. Moreover, the corporation's financial condition must be considered in establishing salaries. Finally, because the insiders themselves determined their compensation, they bear the burden of proving the fairness and good faith of that compensation.³⁰

B. Corporate Payments on Guaranty

1. Issue

Former owner sells corporate stock to new owner through an installment note executed by the new owner and secured by a corporate guaranty and all corporate assets. The corporation then makes all payments due on the note. The corporation files for relief under chapter 7 of the Bankruptcy Code more than four years after the transaction and trustee sues former owner to recover four years' worth of note payments. Former owner defends on the basis that the corporation's payments were made on the guaranty, and that the guaranty can no longer be avoided.

2. Rule

There is a split of authority on this issue. Compare *In re NextWave Personal Communications, Inc.*, 235 B.R. 277 (Bankr. S.D.N.Y. 1999) and *In re Michigan Machine Tool Control Corp.*, 381 B.R. 657 (Bankr. E.D. Mich. 2008) with *In re Advanced Telecommunication Network, Inc.*, 490 F.3d 1325 (11th Cir. 2007).

In *NextWave*, the Chapter 11 debtor-in-possession, in its capacity as high bidder at a government auction of licenses to provide personal communication services at given band of radio spectrum, sued to avoid the purchase transaction, in exercise of its strong-arm powers, as

²⁸ Practical tip: Be sure to check the company's and principal's tax filings to see what they reported as compensation for the principal.

²⁹ *Glenmore Distilleries Co. v. Seideman*, 267 F. Supp. 915, 919 (E.D.N.Y. 1967); *Lunsford v. Haynie*, 175 F.2d 603, 606 (5th Cir. 1949) (holding salary "wholly disproportionate to his services" and therefore recoverable by trustee); *Heise v. Earnshaw Publications, Inc.*, 130 F. Supp. 38, 40 (D. Mass. 1955) (stating that salaries should not be raised beyond fair value of services).

³⁰ See *In re Lifschultz Fast Freight*, 132 F.3d 339, 354–55 (7th Cir. 1997) (burden to show "fairness and good faith" of raise and retroactive raise shifts to insiders once substantial factual basis of impropriety established); *Lunsford*, 175 F.2d at 606 (The "burden lies heavily on [insider] to show that the exacted salary was reasonable").

constructively fraudulent under state law. To prevail on its strong-arm claim, the Chapter 11 debtor had to demonstrate that it (1) incurred an obligation; (2) either at time when it was engaged, or was about to engage, in business or transaction for which its remaining assets were unreasonably small, or at time when it intended to incur, or believed or reasonably should have believed that it would incur, debts beyond its ability to pay; and (3) for which it did not receive reasonably equivalent value.³¹ Generally an obligation is incurred when a debtor becomes legally obligated to pay.³² While the Bankruptcy Code is silent on the question of when a debt or obligation is “incurred,” courts have not questioned that an “obligation” to pay principal indebtedness under a promissory note is “incurred” on the date the note is executed and delivered.³³

In *Michigan Machine Tool Control Corp.*, the chapter 7 trustee filed an adversary complaint against several transferees, three of whom were among the debtor's original shareholders and one of whom held notes payable by the debtor as a result of her divorce from another of the shareholders. The trustee asserted that interest payments that the debtor made to transferees in connection with its repurchase of stock were fraudulent transfers and/or improper shareholder distributions under Michigan law, and sought subordination and disallowance of transferees' claims. The Bankruptcy Court held that the monthly interest payments made by the chapter 7 debtor to its original shareholders in connection with its repurchase of stock were not separate “transfers” under either Michigan law or the Bankruptcy Code, but, instead, a single “transfer” occurred when the debtor entered into binding contracts to redeem the transferees' stock. Thus, the trustee's action for constructive fraud, brought more than six years after execution of the contracts, was time-barred as the debtor's obligations were fixed, and it disposed of an asset, when it signed the promissory notes incorporating the terms of the buy-sell agreements, thereby entering into binding contracts to redeem the transferees' stock.³⁴

In *Advanced Telecommunication Network, Inc.*, chapter 11 debtor-in-possession brought adversary proceeding to set aside settlement and settlement payments that it had made as fraudulent as to creditors and to recover from its former director and 50-percent shareholder on breach of fiduciary duty and other theories. The Bankruptcy Court entered judgment in favor of defendants on fraudulent transfer claims on limitations grounds, and also on ground that debtor was not insolvent and allegedly received “reasonably equivalent value.” Debtor appealed. The District Court affirmed and Debtor again appealed. The Court of Appeals held that the corporate debtor did not incur any obligation to make settlement payments, of kind potentially subject to avoidance under New Jersey fraudulent transfer law, at time of drafting of agreement settling shareholder dispute, where corporate debtor did not participate in drafting and did not sign

³¹ 11 U.S.C.A. § 544.

³² 235 B.R. at 289 citing *In re Emerald Oil Co.*, 695 F.2d 833, 837 (5th Cir.1983); *Barash v. Public Finance Corp.*, 658 F.2d 504, 511 (7th Cir.1981); *In re G. Survivor Corp.*, 217 B.R. 433, 440 (Bankr.S.D.N.Y.1998).

³³ *Id.* citing *In re Iowa Premium Service.*, 695 F.2d 1109, 1111-12 (8th Cir.1982); *In re Smith-Douglass, Inc.*, 842 F.2d 729, 730 (4th Cir.1988); *In re Pippin*, 46 B.R. 281, 283-84 (Bankr.W.D.La.1984) (holding that, for preference purposes, debtor becomes legally obligated to pay under installment payment contract when contract is executed).

³⁴ 381 B.R. at 668.

shareholders' informal handwritten agreement; debtor incurred obligation only when shareholder, acting in representative capacity, signed formal agreement on corporate debtor's behalf, less than four years prior to commencement of strong-arm fraudulent transfer avoidance proceeding, within applicable four-year statute of limitations.³⁵ Moreover, even assuming that payment obligation which corporate chapter 11 debtor sought to avoid in strong-arm proceeding was incurred more than four years prior to commencement of proceeding, outside applicable four-year statute of limitations, upon drafting of settlement agreement between its shareholders, bankruptcy court should not have dismissed avoidance proceeding in its entirety, where debtor had asserted claim to avoid not only its obligation to make settlement payments, but payments themselves, all of which were made less than four years prior to commencement of proceeding.³⁶

C. Corporate Payment of Life Insurance Proceeds

1. Issue

A corporation buys key man life insurance and pays all premiums. When one of two shareholders dies, the corporation uses the proceeds of the policy to "redeem" the widow's shares. The remaining shareholder agrees that he and his deceased co-shareholder intended the widow to be the beneficiary of the policy. However, the corporation has no real net worth so the redeemed shares were worthless. Eventually the corporation files for chapter 7 bankruptcy relief. After receipt of the proceeds, but before the bankruptcy filing, the widow transfers some of the insurance proceeds to a (minor) son, or to her own creditors. What additional defenses do these mediate transferees (i.e. son and creditors) have under §550? Should the chapter 7 trustee bring an avoidance action against them?

2. Rule

The purpose of the subsequent/mediate transferee rule of §550(a)(2) is to provide an alternative source of recovery to a bankruptcy estate with respect to an entity (individual or other) which actually realized the benefit of the fraudulent conveyance made by the debtor.³⁷

For example, in *In re First Financial Associates, Inc.* 371 B.R. 877 (Bkrcty.N.D.Ind., 2007), the chapter 7 trustee's recovery from a third party, as alleged subsequent or mediate transferee of life insurance proceeds that had been received by fiancée of corporate debtor's principal in actual and constructive fraud on debtor's creditors, was limited to those funds that could be traced to avoided transfer, and where trustee failed to show that more than \$50,000 of the \$250,000 that third party received could definitely be traced to this avoided transfer, trustee's recovery could not exceed \$50,000.³⁸ However, receipt of the funds was not conclusive for mediate liability; the third party must have realized the benefit of the transfer. A third party who,

³⁵ 490 F.3d at 1331-32.

³⁶ *Id.* at 1332.

³⁷ *In re First Financial Associates, Inc.*, 371 B.R. 877, 919 (Bkrcty.N.D.Ind., 2007).

³⁸ *Id.* at 917.

in investing fraudulently transferred funds for benefit of his late brother's fiancée, the initial transferee, was not shown to have derived any benefit therefrom, and who, apart from fact that investment account in which funds were deposited was opened in his, rather than in fiancée's name, was not shown to have exercised any control over funds prior to returning them to fiancée, with interest, roughly two months later, could not be regarded as subsequent or mediate "transferee," from whom trustee could recover under Code provision governing the liability of transferees on avoided transfers; indeed, even assuming that third party could be regarded as "transferee" based on fact that his name appeared on investment account, he was entitled to assert statutory "good faith" defense to any liability to trustee.³⁹

D. Prepetition Waiver of Fraudulent Transfer Claim

1. Issue

A prepetition lease or financing contract has a "hell or high water" clause by which the debtor has released all claims and defenses. Postpetition, the chapter 11 debtor claims that the goods were not delivered and therefore that the contract was a fraudulent transfer. Can a debtor waive a fraudulent transfer claim prepetition? Does the debtor's prepetition all-inclusive waiver bind the debtor postpetition?

2. Rule

It is relatively undisputed that courts will not enforce agreements waiving the right to file for bankruptcy or waiving certain consequences of a bankruptcy filing.⁴⁰ Likewise, it was long assumed that specific rights, effects, or obligations provided by the Bankruptcy Code could not be waived in advance. Both emerging jurisprudence and new business practice are calling this assumption into question. With increasing regularity, loan documents and workout agreements contain clauses waiving the applicability of the automatic stay if the borrower files for bankruptcy; the agreement may contain a clause providing that "the borrower will not oppose the lender's motion" to obtain relief from the automatic stay or that the collateral is "not necessary to an effective reorganization."⁴¹ This issue has not yet produced an overwhelming amount of published case law, but the decisions thus far are creating significant uncertainty. Apparently no court has found a waiver to be self-executing,⁴² but some courts have enforced these

³⁹ *Id.* at 917-19.

⁴⁰ See, e.g., *In re Weitzen*, 3 F. Supp. 698 (S.D.N.Y. 1933), citing *Federal Nat 'l Bank v. Koppel*, 148 NE 379 (Mass. 1925); *In re Madison*, 184 B.R. 686 (Bankr.E.D.Pa.1995) (agreement not to file bankruptcy for certain time period is not binding).

⁴¹ Other clauses provide that filing a petition will constitute "bad faith" if intended to forestall foreclosure, or that the debtor agrees to admit the existence of facts that will support a case dismissal order. See, generally, Edward S. Adams & James L. Baillie, "A Privatization Solution to the Legitimacy of Prepetition Waivers of the Automatic Stay, 38 Ariz. L. Rev. 1, 26 (1996) (listing some sample clauses).

⁴² Michael St. Patrick Baxter, "Prepetition Waivers of the Automatic Stay: A Secured Lender's Guide," 52 *The Business Lawyer*, 577, 591 (1997) (reporting that there is "no disagreement" that stay waivers are not self-executing).

provisions.⁴³ Other courts have declined to uphold waivers in the cases before them, but have suggested that waivers may be enforceable in other cases.⁴⁴ Still other courts have held that waivers are unenforceable per se.⁴⁵

Commercial law generally refuses to recognize advance waivers of statutory rights or obligations related to enforcement of remedies or debt collection. Parties in secured transactions, for example, cannot execute loan documents that waive certain collection remedies provided by Article 9 of the Uniform Commercial Code.⁴⁶ Similarly, procedures and remedies provided in state mortgage foreclosure laws generally cannot be waived. Bankruptcy law is consistent in this regard, as it also reflects a clearly articulated policy disfavoring pre-bankruptcy agreements that attempt to circumvent some of the consequences of a bankruptcy. For example, section 541(c) of the Bankruptcy Code expressly invalidates any pre-bankruptcy agreement that precludes an item from becoming property of the estate. Similarly, in its governance of non-loan executory contracts and leases, section 365 renders unenforceable contract provisions that in any way are conditioned on a party's bankruptcy filing to insulate the non-debtor party from the effects of that bankruptcy.⁴⁷

Because bankruptcy law provides clear rules of treatment on which all parties can rely, it supplants private agreements or transactions that do not comport with the statutory rules, notwithstanding the good faith of the parties. For example, certain pre-bankruptcy transactions can be set aside or avoided under sections 544, 546, 547, and 548. In addition, the Bankruptcy Code establishes a statutory scheme of priority and treatment for certain types of creditors.⁴⁸ If voluntary creditors wish to obtain priority treatment in the event of a borrower's bankruptcy, they can take a security interest rather than lending on an unsecured basis. They cannot, however, bargain with the prepetition debtor to be treated in a way that violates the priority scheme.⁴⁹

⁴³ See, e.g., *In re Powers*, 170 B.R. 480, 483 (Bankr. D. Mass. 1994).

⁴⁴ *In re Club Tower, L.P.*, 138 B.R. 307, 311 (Bankr. N.D. Ga. 1991).

⁴⁵ See, generally, *In re Pease*, 195 B.R. 431, 434 (Bankr. D. Neb. 1996) (in individual chapter 11 case, finding automatic stay waiver in "Debt Resolution Agreement" unenforceable per se).

⁴⁶ Section 9-501(3) explicitly precludes waiver of many of the significant provisions of Article 9, such as those delineating the methods of disposition of collateral, borrower's right to redeem the collateral, and liability of a secured party for failure to comply with such rules. See U.C.C. §§9-505, 9-506, 9-507.

⁴⁷ See, e.g., 11 U.S.C. §365(b)(2), (e)(1).

⁴⁸ See, e.g., 11 U.S.C. §§503, 506, 507.

⁴⁹ *Chapter 11 Working Group Proposal #9: Pre-Bankruptcy Waivers of Bankruptcy Code Provisions*, <http://www.abiworld.org/AM/Template.cfm?Section=Search&template=/CM/HTMLDisplay.cfm&ContentID=36461> (Accessed February 4, 2009).