

ABI Annual Meeting 2009

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

**INITIAL AND SUBSEQUENT TRANSFEREE
ISSUES UNDER 11 U.S.C. § 550**

Written Materials Prepared By:

Sheryl L. Toby
Dykema Gossett PLLC
400 Renaissance Center, Suite 2300
Detroit, MI 48243
(248) 203-0522
stoby@dykema.com

and

Melissa S. Byrd
Dykema Gossett PLLC
400 Renaissance Center, Suite 2300
Detroit, MI 48243
(248) 203-0819
mbyrd@dykema.com

In the time of a weakening economy, creativity abounds as new and innovative ways are discovered to litigate issues. Bankruptcy Code section 11 U.S.C. §550 has been used inventively to seek recovery from third parties of transfers originated from debtor assets. Take for example the following simple factual scenario: A company files bankruptcy and transfers funds to a related corporation, which transfers the funds to a third party (ex: uses the funds to pay off its own debts). The debtor corporation does not pursue its related company for recovery on fraudulent conveyance theory, but instead pursues the deep pocket “subsequent transferee” of the funds. The question becomes: can an action be maintained against the subsequent transferee under §550 without first avoiding the transfer against the initial transferee? The answer to the question is that the cases are split and the analysis primarily depends on the interpretation of §550 and whether actions can be maintained directly against a subsequent transferee or whether there must have first been an “avoided transfer” against an initial transferee.¹ Section 550 is entitled “Liability of transferee of avoided transfer” and states in pertinent part:

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.** (emphasis added).

The Tenth Circuit has held that the trustee could not avoid a subsequent transfer without first having avoided the initial transfer. In Weinman v. Simons (In re Slack-Horner Foundries Company), 971 F.2d 577 (10th Cir. 1992), the trustee attempted to avoid a prepetition tax deed conveying property formerly belonging to debtor. The Debtor had failed to pay property taxes on a piece of real estate it owned. Because of the unpaid taxes, a lien was placed on the

¹ It should be noted that this article is limited to addressing just certain specific questions raised, such as, whether the action can be brought without first pursuing the initial transferee, and does not address other defenses or issues that may also exist under §550.

property, and the lien was then sold at public sale to George Simons (“Simons”). Simons paid the property taxes over the next several years, and when debtor failed to redeem the property within the allotted time, Simons obtained a treasurer’s deed, which effectively vested all the title and interest in the property to Simons. Less than one year after the deed was issued, debtor filed bankruptcy. The trustee brought a § 548 action against Simons. The Court found that the state was the initial transferee of the property, and thus, Simons was a subsequent transferee. The Court opined:

Under the Bankruptcy Code, Simons is considered an immediate transferee of the initial transferee. Although § 550 of the Code authorizes the trustee in certain circumstances to recover the value of the property transferred from either the initial transferee or a subsequent transferee (see 11 U.S.C. § 550(a)(1) and (a)(2)), in order to recover from a subsequent transferee the trustee must first have the transfer of the debtor’s interest to the initial transferee avoided under § 548. See § 550(a): “[T]o the extent that a transfer is avoided under section ... 548 ... the trustee may recover, for the benefit of the estate, the value of such property from [the initial transferee or any immediate transferee of the initial transferee.] (emphasis in original).

Slack-Horner, at 580.

The dissenting judge, however, pointed out that no other cases to date had supported the majority’s decision. Id. at 582 (Seymour, J., dissenting). Two courts have since followed the holding in Slack-Horner. See Enron Crop. v. Int’l Fin. Corp. (In re Enron Corp.), 343 B.R. 75, 81 (Bankr. S.D.N.Y. 2006) (examining both Slack-Horner and In re Int’l Admin. Servs., Inc., infra, and determining that “The plain language of the bankruptcy code...provides that recovery may be sought ‘to the extent that a transfer is *avoided* under [the avoidance sections]’ [emphasis added]. Thus, a prerequisite to the ultimate recovery is the actual avoidance of a transfer.”); see also Greenwald v. Latham & Watkins (In re Trans-End Technology, Inc.), 230 B.R. 101, 104 (Bankr. N.D. Ohio 1998) (“The language of § 550 is unarguably both unambiguous and plain

and it clearly provides for the recovery of fraudulent transfers from initial and subsequent transferees ‘to the extent that the transfer is *avoided* under section...548..’ 11 U.S.C. § 550(a) (emphasis added).”). However, to date, these are the only three courts to follow this line of reasoning.

In 2005, the Eleventh Circuit, to the contrary, followed the opposite path when it held “that Section 550(a) does not mandate a plaintiff first to pursue recovery against the initial transferee and successfully avoid all prior transfers against a mediate transferee.” IBT International, Inc. v. Northern (In re Int’l Admin. Servs., Inc.), 408 F.3d 689, 708 (11th Cir. 2005). In Int’l Admin. Servs., Charles Givens, the founder of International Administrative Services (“IAS”), operated get rich quick schemes in the form of giving financial advice. Upon these schemes beginning to unravel, Givens, in an attempt to shield IAS’s assets, transferred the assets through various foreign and domestic entities. The assets were transferred over a hundred times through twenty-three different entities eventually landing in an entity in which the sole shareholder of IAS held an interest. In the end, the trustee sought turnover under 11 U.S.C. §§544(b), 542 and 550, from two different entities, IBT International (“IBT”) and Southern California Sunbelt Developers, Inc. (“SCSD”), as they had received \$1,050,000 from IAS through the transfers, though the path of the assets was hard to follow. After a trial presenting evidence on this complex scheme of money laundering, the bankruptcy court entered a money judgment against IBT and SCSD in the amount of \$1,679,251.30. The ruling was appealed to the district court, which affirmed the bankruptcy court’s ruling.

On appeal to the Eleventh Circuit, the court framed the question “whether an action must first be brought against the initial transferee as a prerequisite to seeking recovery against other parties who may be liable.” In re Int’l Admin. Servs., Inc., supra, at 704. Although the court

recognized that the language of §550 states that “to the extent a transfer is *avoided*,” the court nevertheless found that “[t]he strict interpretation of §550(a) produces a harsh and inflexible result that runs counterintuitive to the nature of avoidance actions. If the initial transaction must be avoided in the first instance, then any streetwise transferee would simply transfer the money or asset in order to escape liability. The chain of transferees would be endless.” *Id.* at 704. Consequently, the court considered alternative approaches to reach the conclusion that the lawsuit could be maintained even though the transfer had not been avoided.

The first approach considered was whether the other entities through which the funds first traveled were mere conduits leaving the recipient of the funds as the “initial transferee.” However, the court ultimately rejected this defense and found that the “mere conduit” rule is usually only applied where the initial recipient of the funds is an innocent intermediary in a transaction in which it is not ultimately the recipient of the funds, such as, where a bank acts as an intermediary. *In re Int’l Admin. Servs., Inc.*, *supra*, at 705. Here, the initial transferees were not innocent so the “mere conduit” theory was not applicable. Instead, the Court focused on the language of §550 and interpreted the word “avoided” to mean “avoidable.” The court then adopted the holding in *Kendall v. Sorani (In re Richmond Produce)*, 195 B.R. 455, 463 (Bankr. N.D. Cal. 1996), quoting, “‘once a trustee proves that a transfer is *avoidable* ... he may seek to recover against any transferee, initial or immediate, or an entity for whose benefit the transfer is made.’ (Emphasis added). The court stated that an interpretation of Section 550 mandating actual avoidance of initial transfers, ‘conflates Chapter 11’s avoidance and recovery sections.’” *Int’l Admin. Servs.*, *supra*, at 706. Noting that its reading of §550 does not comport with a strict construction, the Court focused on the words “to the extent that” and found that these words focus on the concept that a transferee may be protected under other provisions such as the

protections afforded to a good faith transferee that takes for value. Hence, the court adopted the reasoning in Richmond Produce, that “‘to the extent that’ simply appreciates ‘that transfers sometimes may be avoided only in part, and that only the avoided portion of a transfer is recoverable.’” *Id.* (quoting Richmond Produce, *supra*, at 463.)

Most recently, in the case of Woods & Erickson v. Leonard (In re AVI, Inc.), 389 B.R. 721 (9th Cir. 2008) the Ninth Circuit weighed in on the topic, further following the holding in Int’l Admin. Servs. In AVI, Inc., the law firm of Woods & Erickson (“W&E”) represented AVI and its parent company Air Vegas Enterprises, Inc. (“AVEI”) prepetition, prepared debtor’s chapter 11 petition and schedules and represented debtor upon the filing of its bankruptcy case. W&E then withdrew as attorney of record due to a conflict that predated the filing. A dismissal of the bankruptcy case was entered without notice. Thereafter, W&E assisted debtor in a sale of flight allocations and related intangibles to Maverick Helicopters for \$1 million. Prior to this sale, a party in the original chapter 11 case filed a motion seeking to have the bankruptcy case order of dismissal vacated due to, among other things, faulty notice and fraud. W&E received notice of the motion prior to concluding the sale. The court found that the dismissal order was fatally defective, vacated the dismissal order, reinstated the bankruptcy case and converted it to chapter 7. The trustee then commenced a number of lawsuits including a §549 proceeding against Maverick Helicopters to avoid the transfer of the flight allocations as an unauthorized post petition transfer. Some of the sale proceeds were transferred from Maverick, to AVEI and then to W&E. The trustee sought to recover the amounts transferred to W&E. While Maverick Helicopters and other defendants settled, the action against W&E proceeded to trial. The bankruptcy court first found that the trustee met his burden to demonstrate avoidance of the sale of Maverick Helicopters under §549. The bankruptcy court then found that under §550, W&E

was a transferee of the funds from the sale because the payment that W&E received was traceable to the proceeds of that sale. Debtor had transferred the sale proceeds to AVEI which had then paid the \$32,808.78 to W&E. As AVEI only had \$1,700 in the relevant bank account at the time, the monies were readily traceable. The bankruptcy court entered judgment against W&E.

The Ninth Circuit, addressing this matter of first impression in the Circuit, held, “a trustee, subject to the requirement of establishing avoidance, may prosecute an action to recover from a subsequent transferee under §550 without having earlier avoided the initial transfer.” *Id.* at 724. The Court found that, “[u]nder a strict construction of §550, the trustee would be precluded from pursuing subsequent transferees after settling with the initial transferee who does not admit liability. In turn, trustees would have little incentive to partially settle avoidance actions, thereby running up the costs of litigation and causing further delay.” *Id.* at 735. After contemplating the plain language of the statute, congressional intent, current case law and practical ramifications, the Court went on to state:

Accordingly, in construing the plain language of §550 and the statutory framework as a whole, we conclude that Congress intended avoidance actions as one remedy and recovery as another. Thus, we hold that a trustee is not required to avoid the initial transfer from the initial transferee before seeking recovery from subsequent transferees under §550(a)(2). This view of §550 is compatible with the avoidance sections.

AVI, Inc., *supra*, at 735.

We note that in each of the above cases that have held that an action need not be brought against the initial transferee before maintaining the action against the subsequent transferee, there appears to have been some intentional wrong doing on the part of the subsequent transferee. A strict interpretation of §550 barring the actions would have led to a harsh or “unfair result.” While the courts did not specifically state that the equities of the matter were swaying

their interpretation of the statutory language, in at least one case, the court clearly mentioned a strict interpretation as yielding an unfair result. IBT International, Inc. v. Northern (In re Int'l Admin. Servs., Inc.), supra, 408 F.3d at 704. However, in the case of an innocent subsequent transferee, a failure to strictly interpret the statute to bar the action without first proceeding against the initial transferee may also result in an equally anomalous result.

What if the example fact pattern raised at the beginning of this article was modified slightly? In the new fact pattern, the debtor corporation does bring an avoidance action against its related corporation as the “initial transferee” and the related corporation defaults. Technically, the transfer has now been avoided. Is this sufficient to establish liability against the subsequent transferee for purposes of §550?

There are a few cases in which trustees have attempted to pursue intermediate or mediate transferees based upon a default judgment against an initial trustee or a settlement with the initial transferee who admitted liability. For instance, in Thompson v. Jonovich (In re Food and Fibre Prot., Ltd.), 168 B.R. 408 (Bankr. D.Az. 1994) the court determined that a default judgment avoiding transfer as to the initial transferee did not bind the subsequent transferee without proof all the elements of the preference or fraudulent conveyance because the subsequent transferee, as an immediate or mediate transferee, was entitled to assert a good-faith defense. There, the Court found that the theory that the default judgment would apply to subsequent transferees as “unsupported by Rule 55, Fed. Rules Civ. Proc., Rule 7055, Rules of Bkrcty. Proc., or other applicable law.” Id. at 416 (footnote omitted). The Court indicated that on its face, allowing an initial transferee’s default judgment to bind a subsequent transferee appears to contradict due process. Id. at 415. The Court stated that to rule otherwise could lead to “anomalous and unfair results.” Id. Similarly, in Dye v. Sachs (In re Flashcom, Inc.), 361 B.R. 519 (Bankr. C.D. Ca.

2007), when an initial transferee stipulated that a transfer was avoidable as a preferential transfer, the stipulation was not binding on subsequent transferees. The Court in Flashcom determined, “[t]o interpret §§ 547 and 550 [the opposite] way would raise substantial due process concerns, and would lead to anomalous results.” Id. at 524 (citing In re Food and Fibre, *supra*). The Courts in these cases have established that the due process rights of the subsequent transferees must be protected.

In conclusion, it appears that the courts are not in complete agreement regarding the interpretation and application of §550 in actions to recover against subsequent transferees. Consequently this leaves room for creative litigation in both asserting and defending cases.