

Alert

Fifth Circuit Narrows Meaning of 'Value' in Good Faith Lender's Fraudulent Transfer Defense

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The U.S. Court of Appeals for the Fifth Circuit, on Oct. 16, 2014, held that a "good faith transferee" in a fraudulent transfer suit "is entitled" to keep what it received "only to the extent" it gave "value." *Williams v. FDIC (In re Positive Health Management)*, 2014 WL 5293705, at *8 (5th Cir. Oct. 16, 2014). Reversing in part the district and bankruptcy courts, the Fifth Circuit narrowed their holding that the debtor had "received reasonably equivalent value in exchange for the debtor's cash transfers." *Id.* at *1-2. In effect, the court of appeals disregarded the value of indirect economic benefits that had been relied upon by a good faith lender as an affirmative defense to the trustee's fraudulent transfer claim.

The trustee had proved the debtor made the cash "transfers [to a lender] with actual intent to hinder, delay, or defraud" creditors under Bankruptcy Code ("Code") Section 548(a)(1)(A), but the Fifth Circuit limited the good faith transferee's affirmative defense under Code Section 548(c) ("good faith ... transferee ... may retain any interest transferred ... to the extent that [it] gave value to the debtor in exchange for such transfer ...") (emphasis added). Most important, the court rejected the reasoning of other lower courts that held the term "value" in Section 548(c) to mean "reasonably equivalent value." *See, e.g., In re Churchill Mortg. Inv. Corp.*, 264 B.R. 303 (S.D.N.Y. 2001), *affirming* 256 B.R. 664, 677 (Bankr. S.D.N.Y. 2000) ("reasonably equivalent value in Section 548(a)(1)(b) ... and 'value' in Section 548(c) ... have the same fundamental meaning").

Issues

The Fifth Circuit framed the following issues in *Williams*: "[W]hat happens when a transferee gave less value to the debtor than it received[?]. Is the transferee allowed to keep all that it received so long as it gave 'reasonably equivalent' value in exchange? Or is netting required so that the transferee keeps only the value that it gave to the [d]ebtor?" *Id.* at *1. The court answered the second question negatively and the last question affirmatively.

Facts

The corporate debtor occupied space in an office building owned by an affiliate subject to a mortgage held by a bank ("Bank"). As "rent" for the office space, the debtor paid the Bank approximately \$368,000 over a one-year period prior to bankruptcy, but the market rent for equivalent property was roughly \$253,000. The bankruptcy trustee sued the Bank, alleging that the debtor's payments to it were fraudulent transfers under Code Section 548 because the debtor used its cash to pay the mortgage obligation of its affiliate and failed to receive reasonably equivalent value in exchange. *See, e.g., In re B-F Bldg. Corp.*, 312 F.2d, 691, 694 (6th Cir. 1963) ("In the usual case ... the payment of another's debt is held to be a transfer without fair consideration.").

The Lower Courts

After a three-day trial, the bankruptcy judge submitted proposed findings of fact and conclusions of law to the district court. He found that the debtor had received reasonably equivalent value because, among other things, the \$368,000 paid by the debtor constituted “reasonable rent” for use of the office space based on a 2006 appraisal showing that the reasonable rental value for the space was roughly \$253,000. The bankruptcy judge reasoned that: (1) the payment to the Bank enabled the debtor to save market rent [\$253,000] for use of the office space (“Rent Savings Benefit”); and (2) the Bank’s “forbearance from foreclosing” on the office building allowed the debtor to “generate cash flow from operations that ultimately earned the [debtor] over \$4 million in revenue” (the “Indirect Economic Benefit”). 2014 WL 5293705, at *4. Accordingly, the bankruptcy judge recommended dismissal of the trustee’s entire constructive fraudulent transfer claim.

The bankruptcy court nevertheless found that the debtor had made the payments to the Bank “with actual intent to hinder, delay, or defraud” creditors, relying on Code Section 548(a)(1)(A). *Id.* at *2. In particular, it relied on the debtor’s “deteriorating financial condition” plus pending “lawsuits and judgments around the time of the transfers.” *Id.*

The Bank asserted the value-in-good faith affirmative defense contained in Code Section 548(c). Because it found that the Bank had, in good faith, given “value in exchange for the transfers” [i.e., the Rent Savings Benefit and Indirect Economic Benefit],” the bankruptcy court held the Bank “could keep [all] the funds” it received from the debtor. *Id.* The district court adopted the bankruptcy court’s findings, agreeing that the Bank had given value [i.e., the Rent Savings Benefit and the Indirect Economic Benefit] to the debtor “beyond the rental value of the property.” *Id.*

The Court of Appeals

The Fifth Circuit affirmed the fraudulent transfer finding and the judgment that the Bank was entitled to the good faith defense. Nevertheless, it reversed the district court’s “take-nothing judgment in favor of” the Bank, enabling the trustee “to recover the \$114,348.02 difference between the payments [the Bank] received and the value it gave in return.” *Id.* at *8. Thus, the court completely disregarded the Indirect Economic Benefit received by the debtor.

The court first explained why a good faith transferee for value may retain any property it received to the extent that it gave value in exchange for the debtor’s transfer, noting that “section 548(c) ‘protects the [good faith] transferee from his unfortunate selection of business partners.’” *Id.* at *3, quoting *In re Hannover Corp.*, 310 F.3d, 796, 802 (5th Cir. 2002). Nevertheless, in the court’s view, the Indirect Economic Benefit here did not constitute “value” under Code Section 548(c), for “value” must be measured from the transferee’s perspective. *Id.* at *4. “[T]his court looks not to ‘the transferor’s gain,’ but rather to the value that the transferee gave up as its side of the bargain.” *Id.* Despite the Bank’s good faith in receiving funds from the debtor, the Fifth Circuit ignored as “irrelevant” the debtor’s receiving “outsized benefits from [the Bank’s] forbearance.” *Id.*

The Fifth Circuit agreed with the trustee that, unlike the lower courts, it had to “reduce the value of the fraudulent transfers (\$367,681.35) by the value of the market rent (\$253,333.33), and to award” the trustee “the \$114,348.02 difference.” *Id.* at *5. The court rejected the bankruptcy court’s “looser approach” that had enabled the Bank “to keep the entirety of the [cash] transfers” because the Rent Savings Benefit and Indirect Economic Benefit were “‘reasonably equivalent’ to the amount of the transfer.” *Id.* According to the Fifth Circuit, “value” under Code Section 548(c) does not mean

“reasonably equivalent value.” *Id.* The two terms, reasoned the court, have “distinct meanings.” *Id.* at *6. “It is unlikely that the drafters of the Bankruptcy Code intended ‘value’ under section 548(c) to mean ‘reasonably equivalent value’ when the latter term is explicitly used in another subsection of the same statute (section 548(a)’s provision for constructive fraudulent transfers).” *Id.*

The terms of Code Section 548(c) thus “support ... the [Fifth Circuit’s] netting approach.” *Id.* at *7. Its “to the extent” language means “that a transferee is entitled to keep only the amount of a fraudulent transfer that equals the amount it gave up in exchange.” *Id.* It is “because transferees who merely give ‘good consideration’ in exchange for fraudulent transfers are entitled to the defense that netting is necessary.” *Id.* (emphasis in original). “And because consideration may be disproportionately small, to hold that a transferee who merely gives ‘good consideration’ in exchange for a fraudulent transfer may keep the entire amount would allow it to benefit at the expense of the debtor’s creditors” *Id.* “[D]ollar-for-dollar netting is both practicable and important in balancing the interests of creditors with the interests of transferees.” *Id.* at *8.

Comment

The *Williams* decision is troubling because it eliminates “indirect economic benefits” from being counted as “value” when asserted by a transferee under Section 548(c) of the Code. That holding is inconsistent with the established body of appellate cases that have found “indirect economic benefits” constitute “value” at least when determining whether a debtor received “reasonably equivalent value” in a constructive fraudulent transfer claim under Section 548(a)(1)(B) of the Code. *See Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979, 991 (2d Cir. 1981); *Harman v. First American Bank of Md. (In re Jeffrey Bigelow Design Group, Inc.)*, 956 F.2d 479, 485 (4th Cir. 1992); *In re Xonics Photochemical, Inc.*, 841 F.2d 198, 200 (7th Cir. 1988); *Mellon Bank, N.A. v. Official Comm. of Unsecured Creditors of R.M.L., Inc. (In re R.M.L., Inc.)*, 92 F.3d 139, 155-56 (3d Cir. 1996) (“the mere ‘opportunity’ to receive an economic benefit in the future constitutes ‘value’ under the Code”); *In re Young*, 82 F.3d 1401, 1415 (8th Cir. 1996) (the correct way to determine “value” was not to define it “only in terms of tangible property or marketable financial value,” but instead to “examine ... all aspects of the transaction and carefully measure ... the value of all benefits and burdens to the debtor, direct or indirect, including ‘indirect economic benefits’”).

The *Williams* decision, as it relates to netting under Section 548(c), is consistent with other appellate rulings. *In re Wes Dor Inc.*, 996 F. 2d 237, 243 (10th Cir. 1993) (transferee liable for amount of transfer less value extended to debtor in exchange for that transfer); *In re JTS Corp.*, 617 F. 3d 1102, 1106, 1120 (9th Cir. 2010) (good faith transferee entitled to offset value paid for property and entitled to additional settlement credit for amount paid by settling co-defendants).

Williams confirms a rare split between Congress when drafting Code Section 548(c) in 1978 and the National Conference of Commissioners on Uniform State Laws when drafting Section 8(a) of the Uniform Fraudulent Transfer Act (“UFTA”) in 1984. UFTA Section 8(a) provides a complete affirmative defense for the good faith transferee of a fraudulent transfer made “with *actual* intent to hinder, delay, or defraud any creditor” if the transferee provided “reasonably equivalent value.” Indeed, the Fifth Circuit in *Williams* noted that only the UFTA “gives the transferee a *complete* defense” if it “gave reasonably equivalent value for the exchange.” *Id.* at *6, quoting 5 Collier, *Bankruptcy* ¶ 548.09[5] (16th rev. ed. 2014) (emphasis added by court).

In *Williams*, the trustee sued only under federal law (Code § 548(a)) to attack the debtor's transfers. Had this action been brought by a receiver, a creditor or even the trustee under state law (i.e., the UFTA), the Bank would have had a complete defense. Instead, the trustee in *Williams* shrewdly relied only on federal law (Code § 548(a)) to attack the payments to the Bank. See *generally* Comment, UFTA § 8(a) (1984) ("a complete defense to" action based on actual intent; transferee has "burden of establishing good faith and the reasonable equivalence of the consideration exchanged"); Cook & Mendales, "The Uniform Fraudulent Transfer Act: An Introductory Critique," 62 *Am. Bankr. L.J.* 87, 94 (1988) ("The UFTA creates a common sense defense [and] insulates the innocent transferee, ... making only the collusive transferee liable.").

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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