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Fifth Circuit Holds That Debtor's Control of Funds in Another Entity's Bank Account Made it *De Facto* Owner in Fraudulent Transfer Cases

MICHAEL L. COOK

In this article, the author analyzes a recent court decision that shows how courts, if presented with enough persuasive facts, can and should cut through a maze of offshore shell companies created solely to channel money between investors and actively operating affiliates.

The U.S. Court of Appeals for the Fifth Circuit recently held, in a case of first impression, that a debtor's transfer of funds to corporate insiders from another entity's bank account was a fraudulent transfer.[1] According to the court's decision in *In re IFS Financial Corp.*, the debtor "exercised such control over these accounts that it had de facto control over [them], as well as the funds they contained."[2] The insider defendants had argued unsuccessfully in the lower courts that the debtor did not own the bank accounts from which they received more than $3 million, but the Fifth Circuit, in affirming, held that "control is more decisive than ownership."[3]

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RELEVANCE

Tracing ownership of corporate funds in a messy, fraudulent corporate empire is often impossible. Bankruptcy trustees and unpaid creditors are usually hindered when trying to recover cash held in bank accounts purportedly owned by third parties. *IFS* shows how courts, if presented with enough persuasive facts, can and should cut through a maze of "offshore shell companies created solely to channel money between investors and actively operating" affiliates.[4] By using fraudulent transfer law, the court in *IFS* was able to avoid having to dispose of "any claims based on veil-piercing or earmarking theories."[5]

FACTS

IFS Financial Corporation ("IFS") and seventeen affiliated entities were chapter 7 debtors that had been engaged in the international insurance, mortgage and banking services industries.[6] Many of the affiliates "did no more than temporarily stow stock in other [affiliates], among which were offshore shell companies," all of which were controlled by one individual and his family.[7] Despite "separate corporate structures, a single advisory board… — also dominated by the…family — oversaw all…operations and gave orders to [the entities'] officers and managers[;] …set interest rates, managed investments, transferred money between [affiliates], and personally handled the sale of assets. No company in [the affiliates'] network operated independently of this board. When the board was not meeting, it entrusted its full authority to [the dominant individual]."[8]

Investors in the enterprise deposited their contributions into three Texas bank accounts, the relevant one here being "in the name of 'Integra Bank." According to the court, the "Integra" account was one of two accounts that "served as the primary stream of funds into [the entire corporate enterprise]…. Although investors were told that their deposits took some distinct, individualized form — such as a certificate of deposit, money market account or bearer note — in reality, the Integra and [another named] accounts pooled all investor funds."[9] "Investors apparently believed that their funds were held in a bank by the name of Integra, rather

than in an account under the name Integra Bank located in Texas."[10] Although an entity known "as Integra Bank did exist," it had operated "out of a physical structure in Curacao"; it "lacked tellers and had little interaction with depositors. Integra Bank was independent from [the debtors] only on paper…. When investors wanted to remove funds they contacted IFS — not Integra Bank. [The dominant individual] or advisory board members approved all withdrawals."[11] IFS and its affiliates eventually became unstable and insolvent. During the pendency of litigation against the group, "the advisory board removed funds belonging to IFS and [its affiliates] from the Integra account and began loaning millions to IFS shareholders and [the defendant] insiders."[12]

THE LOWER COURTS

IFS and its affiliates eventually filed Chapter 7 petitions in a Texas bankruptcy court. The trustee sued the insider defendants, seeking $3 million, relying on the Texas version of the Uniform Fraudulent Transfer Act, made available to the trustee by Bankruptcy Code § 544(b). Although the bankruptcy court rejected the trustee's claims based on veil piercing and earmarking, after "a series of overlapping trials and summary judgment motions," it found as follows:

"• The funds were paid out of an account legally titled in the name 'Integra Bank' but actually owned and controlled by [IFS and its affiliates].

- IFS, acting through its officers and agents, exercised exclusive control over the account.
- The funds were paid on account of antecedent debt but in furtherance of a fraudulent scheme.
- The [defendant insiders] knew or should have known of the fraudulent scheme."[13]

The district court affirmed.

TRANSFER OF DEBTOR'S PROPERTY

The insider defendants argued that IFS was not "the de facto owner of [the] bank accounts for which its allegedly fraudulent transfers passed …. [i.e.,] "such that…the debtor" [had no property] interest…that is voidable…by a creditor….]."[14] Both the bankruptcy and district courts had "held that the account…[was] such an interest…based on what they termed IFS's 'de facto' ownership," and the Fifth Circuit agreed.[15]

The trustee agreed that the debtor "did not legally own" the bank accounts; lacked "signatory authority over those accounts"; neither owned nor held shares in Integra; nobody at IFS "was an Integra officer, director or employee"; and that no "formal document" showed the debtor's "authority over Integra or its accounts."[16] According to the trustee, however, the "lack of formalities merely evince[d] IFS's intent to defraud by intentionally avoiding a paper trail which would allow creditors to easily identify its assets."[17] He stressed "that any money in the Integra…accounts was effectively IFS's," pointing to the debtor's "intentionally absurd organizational structure."[18]

Agreeing with the lower courts and the trustee, the court of appeals found that "control is more decisive than ownership," and held "that control may be sufficient to show ownership in what is ultimately a fact-based inquiry that will vary according to the peculiar circumstances of each case."[19]

The court of appeals relied on Texas law and bankruptcy precedent in holding that "control is the primary determinant of ownership of bank accounts," and "is central to assessing whether they are to form part of a bankruptcy estate."[20] In the view of the court, "the facts of this case illustrate [that] IFS had the ultimate power to transfer funds to others" including the defendant insiders here.[21] Because IFS "obscured its power to transfer in an intentionally complicated corporate structure suggests that control is decisive, and that legal title is irrelevant…. [A] debtor organization has taken care to mask its activities [here] through fictional divisions."[22]

The court of appeals stressed the bankruptcy court's detailed fact findings. "IFS dominated [its] subsidiaries to such an extent that the subsidiaries acted at IFS's directions [;]…the directors and stockholders utilized the

corporate entity as a sham to perpetuate a fraud. A single advisory board controlled all of the [affiliates];…set interest rates on the investments on the Integra [bank] account…; controlled how to invest the money, decided the selling price and date of sale of [affiliated] entities, and decided when to transfer monies from [the affiliates]."[23] Because "IFS used the account…as its general operating fund" and "exercised such control over [the] account…," it had "de facto ownership over the…account…, as well as the funds [it] contained."[24]

TRANSFERS MADE WITH ACTUAL FRAUDULENT INTENT

The Uniform Fraudulent Transfer Act, adopted in Texas, provides, among other things, that a transfer is fraudulent "if the debtor made the transfer…with actual intent to hinder, delay or defraud any creditor of the debtor." Texas Business Commerce Code § 24.005(a)(1). According to the Fifth Circuit, the "statute focuses on the transferor's intent, rather than the transferee's.[25] Affirming the lower courts again, the court found that "IFS faced pending lawsuits and mounting debts just as it liquidated nearly all [of its and the affiliates'] assets," and that it "operated as a fraudulent enterprise at the time of the transfers."[26] Moreover, the court agreed with the trustee's proof that "(1) transfers to the [defendants] were transfers to insiders; (2) IFS concealed its transfers….; (3) IFS made the transfers during its dispute and litigation….; (4) IFS transferred substantially all assets; (5) IFS concealed assets from…creditors through its fraudulent scheme; (6) IFS did not receive reasonably equivalent value for the transfers to the [defendants]; and (7) transfers occurred shortly before or shortly after IFS incurred its direct obligation to [another creditor]."[27]

COMMENT

The *IFS* case confirms the Second Circuit's statement in another fraudulent transfer case where the principal shareholder "created dummy corporations…to hide his assets": "[f]raudulent acts are as varied as the fish in the sea."[28] *IFS* is also consistent with other appellate fraudulent transfer cases.[29]

NOTES

[1] *In re IFS Financial Corp.,* 2012 U.S. App. LEXIS 1706, *15, *22 (5th Cir. 1/27/12).
[2] *Id*., at *22.
[3] *Id*., at *15.
[4] *Id*., at *2.
[5] *Id*., at *8.
[6] *Id*., at *2.
[7] *Id*.
[8] *Id*., at *3.
[9] *Id*., *3-*4.
[10] *Id*., at *4.
[11] *Id*., at *4-*5.
[12] *Id*., at *6
[13] *Id*., at *8, citing *In re IFS Fin. Corp*., 417 B.R. 427 (Bankr. S.D. Tex. 2009).
[14] *Id*., at *9-*13-*14.
[15] *Id*., at *14.
[16] *Id*., at *15.
[17] *Id*., at *15.
[18] *Id*.
[19] *Id*., at *15-*16.
[20] *Id*., at *21.
[21] *Id*., at *20.
[22] *Id*.
[23] *Id*., at *21-*22.
[24] *Id*., at *22.
[25] *Id*., at *23, citing *SEC v. Res. Dev. Int'l, LLC*, 487 F.3d 295, 301 (5th Cir. 2007) ("'[T]he transferees' knowing participation is irrelevant under the statute' for purposes of establishing the premise (as opposed to liability) for a fraudulent transfer.").
[26] *Id*., at *25.
[27] *Id*., at *24.
[28] *Salomon v. Kaiser (In re Kaiser)*, 722 F.2d 1574, 1583 (2d Cir. 1983).
[29] *See, e.g., Julien J. Studley, Inc. v. Lefrak*, 66 A.D.2d 208, 214-16, 412 N.Y.S.2d 901, 905-06 (2d Dept. 1979), *aff'd* 48 N.Y.2d 954 (1979) (dominant officer "controlled [affiliates'] destinies…. The manipulation of corporate assets by [defendants] in the face of the [creditor's] rights by preferring the interests of those in control of the corporation reflects bad faith and deprives [the defendants] of the status of transferees for fair consideration.").