Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

7th Circuit Shields Casino from Fraudulent Transfer Charge

Law360, New York (October 22, 2015, 4:24 PM ET) -- So-called "red flags" were not "sufficient to impose a duty on [a gambling casino] to investigate" a Chapter 11 debtor's pre-bankruptcy fraudulent transfers to its insiders who gambled at the casino, held the U.S. Court of Appeals for the Seventh Circuit on Oct. 13, 2015. *In re Equipment Acquisition Resources Inc.* 2015 U.S. App. LEXIS 17805 at *14 (7th Cir. Oct. 13, 2015). Affirming the district court's dismissal of the Chapter 11 plan administrator's complaint against the casino, the court explained that the casino may have "had some indication that the insider's money came from" the debtor, but "it had no reason to suspect that this money was obtained by fraud." Moreover, "even if [the casino] had investigated, it is unlikely — in fact, virtually impossible — that [the casino] would have uncovered the fraud or [the debtor's] financial distress." *Id.* at *14-15

Relevance

Corporate insiders who loot their corporate entities typically spend the cash proceeds. This case addresses the common problem faced by a third party who receives cash from the defrauding insider, but not from the corporate debtor. As the court described its role, it had to "focus on what [the transferee casino] knew about the first link in the chain, from [the debtor] to [the insiders]." *Id.* at *12. Courts therefore conduct a fact-intensive analysis in these cases. *In re Sherman*, 67 F.3d 1348, 1357 (8th Cir. 1995) (transferee with knowledge of at least three badges of fraud with respect to transfer of property had to have knowledge of voidability of transfer; "if transferee possesses knowledge of facts that suggest the transfer may be fraudulent, and further inquiry … would reveal facts sufficient to alert him that the property is recoverable, he cannot sit on his heels, thereby preventing a finding that he has knowledge").

Facts

The insider here and his spouse established the corporate debtor in 1997. Between 2005 and 2009, the debtor "engaged in a scheme to defraud its creditors involving its financing of equipment." *Id.* at *2. "As a result of this scheme," the insider and his spouse "received approximately $17 million in fraudulent transfers" from the debtor. The debtor's creditors and advisers did not detect the scheme until Sept. 29, 2009, almost three months after the debtor had hired a major forensic accounting firm to review its records. As a result, following resignations by all of its officers and directors, the debtor's shareholders elected a chief restructuring officer who caused the debtor to file a Chapter 11 petition in Oct. 2009.

The insider and his spouse "spent large amounts ['over $8 million'] at the [defendant casino]." The insider's "gambling activity" at the casino "was often erratic." *Id.* at *3. He "also made false statements on his … credit application," causing the casino to run credit checks that showed the insider had understated his indebtedness "by over $2 million." Nevertheless, the casino still extended credit. The

insider "also overstated his salary by more than three times his actual salary and claimed to be the owner of [the debtor] even though he was not actually a shareholder … at the time." *Id.* at *4. The casino never verified these statements.

The casino, believing that the insider owned the debtor, "had other reasons to believe that [his] money came from the [the debtor]. Insider paid some of his gambling debts from a bank account in his wife's name "doing business as" the debtor. Finally, one of the insider's "on-file checking accounts listed [the debtor's] corporate address." *Id.* at *5

District Court

After learning of the debtor's fraud, the court-appointed Chapter 11 plan administrator sued in the district court to avoid and recover as fraudulent transfers the cash transfers made to the casino, seeking $8.248 million. The casino moved for summary judgment dismissing the plan administrator's fraudulent transfer claims, relying on the "good faith defense" in Bankruptcy Code Section 550(b)(1) and asserting that "it had acted without knowledge of the fraud" at the debtor. The district court granted the motion, finding that the casino had "accepted the transfers without knowledge of the fraud … and that [the casino] could not have uncovered the fraud even if it had investigated." *Id.* at *7

The Court of Appeals

The plan administrator apparently was unable to recover from the insider. For that reason, he pursued the casino. Although the insider was the "initial transferee of the debtor's funds, the Casino was the immediate" transferee under Code Section 550. This code provision "permits a trustee to recover any transfer avoided … to 'any immediate or mediate transferee of [the] initial transferee.'" *Id.* at *8. Nevertheless, Code Section 550(b)(1) provides a good faith defense when the transferee "takes for value … in good faith, and without knowledge of the voidability of the transfer." The casino's status as an immediate transferee and its having received funds from Insider "for value" were undisputed by the parties. *Id.* Only the casino's good faith and lack of knowledge were at issue.

According to the Seventh Circuit, in affirming the district court, the casino lacked the requisite knowledge. "Here, the money flowed from [the debtor] to [Insider] as a result of fraud and then to [the casino]." *Id.* at *10. Moreover, the "transfer avoided" language in Section 550(b)(1) refers only to the transfer "from the debtor to the initial transferee." Thus, "the statutory context limits 'the transfer avoided' to the transfer between the debtor and the initial transferee [i.e., the insider]. Indeed, it is only the transfer from the debtor to the initial transferee that is avoided under [Code] § 548," not subsequent transfers that are merely recoverable under § 550. *Id.* at *11

Quoting from an earlier decision, the court discussed the "economic justification" behind fraudulent transfer law and acknowledged "limits on the pursuit of transfers and … an important role for creditors to monitor debtors":

> If the recipient of a fraudulent [transfer] uses the money to buy a Rolls Royce, the auto dealer need not return the money to the [debtor] even if the trustee can identify the serial numbers on the bills. The misforture of the firm's creditors is not a good reason to mulct the dealer, who gave value for the money and was in no position to monitor the debtor. Some monitoring is both inevitable and desirable, and the creditors are in a better position to carry out this task than are auto dealers and the many others with whom the firm's transferees may deal.

Id. at *12-13, citing *Bonded Financial Services Inc. v. European American Bank*, 838 F.2d 890, 892 (7th Cir. 1988).

As the court explained here, "unless [the casino] had some reason to know that it was receiving funds resulting from a fraudulent transfer, it should not be liable to [the debtor's] creditors." *Id.* at *13

The "undisputed facts" here, reasoned the court, confirmed that the casino knew nothing about the voidability of the transfer made by the debtor to Insider: It "had no actual knowledge that the transfers arose from fraud at [the debtor] or that [the debtor] was under financial distress." *Id.*

Moreover, most of the so-called "red flags only relate to [Insider] and lack a clear connection to [the debtor]." *Id.* at *14. Nor did the casino have any "reason to suspect that [the] money was obtained by fraud."Finally, "assuming that [the casino] was put on inquiry notice of a fraudulent transfer, a reasonable inquiry would have turned up nothing indicating that the transfers were voidable." It took the debtor's forensic accounting firm "nearly three months to discover the fraud," after gaining full access to the debtor's books and records. The casino's knowledge that the insider's funds might have come from the debtor was clearly "insufficient." *Id.* at *15

The court also rejected the plan administrator's argument that "good faith" should be analyzed separately from the "without knowledge" requirement in Code Section 550(b)(1). Instead, the court focused on the casino's conduct. It was an "innocent third party, not [a] money-washing transferee." *Id.* at *17. In its view, the casino "had no way of knowing the transactions from [the debtor] to [the insider] were voidable, and … was not closing its eyes to the creditors' plight." Nor was there any evidence showing a "lack of diligence by the Casino" due to "bad faith." *Id.* at *18

Comments

Equipment Acquisition Resources is consistent with the decisions of other federal courts of appeals. *See In re Bressman*, 327 F.3d 229 (3d Cir. 2003) (law firms were "good faith" transferees who took "for value … and without knowledge of the voidability of the transfer avoided"; counsel could keep legal fees received in good faith from debtor's fraudulently transferred assets); *In re First Independence Capital Corp.*, 181 Fed. Appx. 524 (6th Cir. 2006) (subsequent transferee found not to have "knowledge" that transfer may be fraudulent when other legitimate explanations for the transfers existed and inquiry would be fruitless since "the party seeking to use the funds for his own benefit was also the only party to whom the bank could make inquiry"); *In re Nieves*, 648 F.3d 232 (4th Cir. 2011) (subsequent transferee had "knowledge" that transfer may be fraudulent when it had "actual knowledge of facts that would lead a reasonable person to believe that the transferred property was voidable").

—By Michael L. Cook, Schulte Roth & Zabel LLP

Michael Cook is a partner in Schulte Roth & Zabel's New York office where he devotes his practice to business reorganization and creditors' rights litigation, including mediation and arbitration.