

Courts Equitably Adjust Transferee Liability

Law360, New York (November 10, 2015, 3:11 PM ET) -- A “bankruptcy court has discretion to award the [bankruptcy] trustee the actual [fraudulently transferred] property or its pre-transfer value,” held the U.S. Court of Appeals for the Seventh Circuit on Oct. 23, 2015. *Hebenstreit v. Kaur*, 2015 U.S. App. LEXIS 18544, at *6-7 (7th Cir. Oct. 23, 2015). Affirming the lower courts, the Seventh Circuit rejected the transferee’s argument that “[s]he should not ... have to pay the value of the [closely held corporation’s] shares when she received them,” and that she “only [had to] return the shares to the bankruptcy estate.” *Id.* at *6. Instead of ordering the return of shares of stock that had declined in value, the court held the transferee liable for the value of the shares at the time of the fraudulent transfer.

Facts

The individual Chapter 7 debtor here had been the majority shareholder of a valuable closely held corporation. He transferred his stock interest to his wife when he became a defendant in a major personal injury suit, leaving himself insolvent.

The bankruptcy court, after trial, held the debtor’s transfer of the stock to be fraudulent. Not only had the debtor made the transfer to his spouse with actual “intent” to harm his creditors, but also for less than reasonably equivalent “value,” resulting in his insolvency.

The transferee asked the bankruptcy court “whether she must pay ... the value of the shares held at the time [the debtor] transferred them to her or whether she could simply return the stock.” Because the stock “had depreciated significantly,” the bankruptcy court held that the defendant had to “pay the value of the shares at the time of transfer,” relying on expert testimony as to the value of the stock at the time. The district court affirmed. *Id.* at *5.

Analysis

The Seventh Circuit explained why the bankruptcy court correctly held the defendant liable for the initial value of the transferred stock. “[R]eturning the stock would not restore the estate’s pre-transfer financial condition because post-[bankruptcy] events significantly decreased the shares’ value.” Also, the Seventh Circuit had “no valid reason to disturb” the lower courts’ “assessment of the stock-valuation testimony of the trustee’s expert.” *Id.* at *7.

Bankruptcy Code Section 550(a) provides in relevant part that “to the extent ... a transfer is avoided ... 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, among others, the initial transferee or any subsequent transferee.

The Hebenstreit decision is consistent with the code and applicable case law. “The purpose of §550(a) is to restore the estate to the financial condition it would have enjoyed if the transfer had not occurred A bankruptcy court ordinarily determines the value of the property to be the value at the time of the transfer but has discretion on how to value the property so as to put the estate in its pretransfer position.” *In re Taylor*, 599 F.3d 880, 890 (9th Cir. 2010). “[T]he language of §550(a) suggests that the default rule is the return of the property itself, whereas a monetary recovery is a more unusual remedy to be used only in the court’s discretion.” *In re Trout*, 609 F.3d 1106, 1113 (10th Cir. 2010).

Whether a court will order the return of the transferred property or its value will turn on the facts of each case. More important, the transferee will have to make its case in the bankruptcy court. As shown below, appellate courts apply an “abuse of discretion” standard of review when considering a bankruptcy judge’s ruling in this context.

Extended Liability for Transferee

When a trustee seeks to recover the value of the property transferred, that recovery is also not limited to the value of the property at the time of the transfer. *United States v. Verduchi*, 434 F.3d 17, 25 (1st Cir. 2006). In that case, the court made an equitable adjustment to a creditor’s recovery when the debtor had fraudulently transferred a home to her son as a gift prior to bankruptcy. The son later mortgaged the home in exchange for \$196,000. The court did not limit the recovery from the transferee son to the value of the home at the time of the transfer under the Rhode Island version of the Uniform Fraudulent Transfer Act. The government, as a creditor, could also recover \$196,000 from the transferee because the government’s tax lien was subordinate to the mortgage. As the court explained, the transferee son “had the benefit of use of the house ..., apparently mortgage-free, until he chose to mortgage the property” and “took [cash] out of the property.” *Id.*

Similarly, in *In re Straightline Investments Inc.*, 525 F.3d 870, 883-86 (9th Cir. 2008), the transferee who bought the debtor’s account receivables in bad faith and engaged in inequitable conduct had no right to limit his liability despite a windfall to the estate. According to the court, the transferee was no “unsuspecting creditor” but a participant in the debtor’s misconduct. *Id.* at 884. He thus lost what he paid for the receivables, the receivables themselves and the amount he had collected from the receivables. *Id.* at 883-84. See also *In re Nostalgia Network Inc. v. Lockwood*, 315 F.3d 717, 719-20 (7th Cir. 2002) (debtor fraudulently transferred money to his fiancée, who then used it to pay the debtor’s personal and business expenses; because of actual fraud, court affirmed judgment against fiancée for full amount: “[T]he fact that some or ... all of [the money] later ... seeped back to the debtor does not legitimize the transfer.”).

Equitable Adjustments for Transferees

Other courts may still permit equitable adjustments for transferees, even those who participate in the debtor’s fraud. *Kingsley v. Wetzel*, 518 F.3d 874 (11th Cir. 2008). In *Kingsley*, the Eleventh Circuit held the bankruptcy court had not abused its discretion in equitably adjusting a recovery from the initial transferee who had colluded in the debtors’ actual fraud but later repaid funds to the estate. In that case, a parent of the individual married debtors knowingly accepted cash from them in order to prevent creditors from seizing those funds. The defendant made certain of repayments back to the debtors, however, prior to their bankruptcy. Following the debtors’ bankruptcy, the trustee sued the defendant to recover all of the funds as a fraudulent transfer. Despite finding actual fraudulent intent by the debtors, the bankruptcy court credited the defendant for his pre-bankruptcy repayments. The Eleventh

Circuit affirmed, reasoning that “recovery of the pre-petition transfers would result in an inequitable windfall to the bankruptcy estate.” Id. at 878. According to the court, federal and applicable state law allows the bankruptcy court to adjust the value of the asset transferred as the equities may require.

These equitable determinations by a bankruptcy court “are subject to review under an abuse of discretion standard.” Id. at 877, quoting *In re General Development Corp.*, 84 F.3d 1364, 1367 (11th Cir. 1996). The bankruptcy court’s decision to credit the defendant by avoiding an “inequitable windfall to the ... estates” fell within the “range of possible conclusions [a bankruptcy] judge may reach.” Id. See also *In re Jackson*, 318 B.R. 5 27-28 (Bankr. D.N.H. 2004), *aff’d* 459 F.3d 117 (1st Cir. 2006) (court reduced judgment when transferee used fraudulently transferred funds to pay debtor’s business and family expenses; full recovery would be a windfall for the estate “in the absence of any finding of actual fraud”).

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