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Sixth Circuit Trims Bank's Good-Faith Defense to Fraudulent Transfer Claims

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The issue of what constitutes a good-faith defense to a fraudulent transfer claim is a murky question that has produced a wide variety of reported decisions from appellate courts over the years. This issue has continued its serpentine course, but a recent Sixth Circuit opinion sheds some clear light on a complicated fact pattern. In this two-part article, we review the Sixth's Circuit's most recent decision in detail and offer some guidance on this thorny question.

Meoli v. Huntington Nat'l Bank

A defendant bank (Bank) in a fraudulent transfer suit "could not prove" its "good faith" defense for loan repayments it received after its "investigator discovered [the] fraudulent past" of the Ponzi scheme debtor's principal, but "failed to disclose that past to [the Bank's account] manager," held the U.S. Court of Appeals for the Sixth Circuit on Feb. 8, 2017. *Meoli v. Huntington Nat'l Bank*, 2017 U.S. App. LEXIS 2248, *28 (6th Cir. Feb. 8, 2017). As for "earlier … loan repayments" made before the investigator's discovery, held the court, "the bankruptcy court erred" in rejecting the Bank's good-faith defense merely because the Bank had "inquiry notice of … fraud." *Id.*

In remanding, the Sixth Circuit directed the bankruptcy court to ascertain whether the Bank's "lack of knowledge of the voidability of the transfers ceased during [the] period" prior to its investigator's discovery of the fraud on April 30, 2004. *Id.* According to the court, "inquiry notice, although sometimes enough to constitute 'knowledge of the voidability of the transfer,' is not necessarily enough in every case." *Id.* at *33. Thus, said the court, the bankruptcy court should make "a holistic review of the facts to determine whether a reasonable person would have been alerted to a transfer's voidability." *Id.*

The Sixth Circuit also affirmed the bankruptcy court's finding that the Bank was a "transferee of the [debtor's] direct and indirect loan repayments" for its affiliate. But the court reversed the lower court's finding that $55 million of the debtor's "excess deposits" into the affiliate's account were transfers "because banks are not 'transferees' with respect to ordinary bank deposits," reasoning that the Bank "did not gain 'dominion and control' over them." *Id.* at *16.

Finally, the Sixth Circuit approved the bankruptcy court's awarding pre-judgment interest at the statutory rate "instead of the market rate." *Id.* at *40. Although the "bankruptcy court satisfied its duty to consider case-specific factors when it considered whether the statutory rate was fair in light of the type of conservative investment that a fiduciary like the Trustee would have pursued," the Sixth Circuit still permitted the lower court on remand "to exercise its discretion to apply a different rate." *Id.* at *43-*44. It did so because its reversal of any "excess deposit" liability reduced the lower court's judgment by "about $55 million." *Id.* at *44.

Relevance

Appellate courts have struggled with the Bankruptcy Code's good-faith defense to fraudulent transfer claims. Just last year, the U.S. Court of Appeals for the Seventh

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Circuit rejected a bank's good-faith defense. The bank had lent approximately $300 million to a company that had capital equal to roughly 1/150th of that amount, yet the debtor was mysteriously "able to secure the entire loan." *In re Sentinel Management Group, Inc.*, 809 F.3d 958, 962 (7th Cir. 2016). According to the Seventh Circuit, the bank, as an initial transferee, was on inquiry notice that the assets securing the loan had been fraudulently pledged to it. *Id*. at 962 (" … merely knowledge that would lead a reasonable, law-abiding person to inquire further — would make him … suspicious enough to conduct a diligent search for possible dirt."). Just three years ago, however, the U.S. Court of Appeals for the Fourth Circuit had approved a lender's reliance on the "good-faith" defense. *Gold v. First Tenn. Bank N.A.*, 743 F.3d 423 (4th Cir. 2014) (2-1) (applying "objective good-faith standard," bank held to have acted in good faith; bank had investigated facts before lending; when debtor offered excuses for non-payment, bank visited collateral "properties," reviewed records and market conditions, consistent with industry practice; bank had no "information" requiring it to "investigate further."). Cases dealing with subsequent transferees such as the Bank in *Meoli* have taken a more nuanced approach. *See, e.g., In re Equipment Acquisition Resources, Inc.*, 803 F.3d 835 (7th Cir 2013) ("Red flags" not sufficient to impose duty on casino to investigate debtor's transfers to insiders; casino may have had a clue that insider's payments came from debtor, but had no reason to suspect fraud; also unlikely that casino would have uncovered fraud).

Relevant Statutory Reference

Bankruptcy Code (Code) § 548(a)(1)(A) enables a trustee to "avoid any transfer" of the debtor's property made within two years of bankruptcy if the debtor made the transfer "with actual intent to hinder, delay, or defraud" present or future creditors. Code § 548(c) provides, in relevant part, that an initial transferee is not liable for the transferred property if it: 1) took the property "in good faith"; and 2) "gave value to the debtor in exchange for such transfer." Code § 550(b)(1), in turn, provides that a subsequent transferee is not liable for the transferred property if it took the property: 1) "for value"; 2) "in good faith"; and 3) "without knowledge of the voidability of the transfer avoided."

Facts

The debtor, T, was a sham company formed by the Bank's borrower, C, "which had crea[ted] it to perpetuate a Ponzi scheme." *Id*. at *2. W "was the Chairman and Chief Executive of" C and had "masterminded [the] Ponzi scheme." *Id*. at *4. Between September 2002 and October 2004, the Bank "had lent about $9 million to C, but by 2004, the loan had grown to $16 million." *Id*. at *5.

T would collect cash from defrauded equipment financiers and deposit the funds into C's bank accounts maintained at the Bank. Although C was the Bank's borrower, T's bankruptcy trustee sought to recover funds transferred by T to C's accounts. The transfers consisted of 1) "direct loan repayments, which [T] sent directly to [the Bank] to pay down [C's] debt to [the Bank]; 2) indirect loan repayments, which [T] sent to [C's] deposit account at [the Bank], and which [C] later used to repay its debt to [the Bank]; and 3) excess deposits [of $55 million] which [T] sent to [C's] deposit account at [the Bank], and which [C] later withdrew or the government later seized." *Id*. at *2.

A Bank employee had discovered that C was receiving bounced checks from T, but neither she "nor her superiors knew what [T] was." *Id*. When the Bank employee asked about T, W "explained that [T] was a recent addition to [C's] holdings" and that it was "not yet operational," but "was already collecting [C's] receivables … ." *Id*. at *6.

Between September, 2003 and April, 2004, the Bank's employees had discovered several troubling facts about C: conflicting descriptions of T as either an affiliate or as an equipment supplier; transfers of large amounts of cash to C; C's refusal to use the Bank's lock-box system; the Bank's employees' doubts about or failure to understand the computer service business; overdrafts on C's accounts; and C's failure to provide the bank with the required audited financial statements.

In April, 2004, the Bank found that C had falsely listed the names of customers who had failed to pay their bills. As a result, the Bank's account managers asked its security department to investigate. The Bank's investigator learned that "the FBI was investigating" C and that W "had a fraudulent past: [he]

had been permanently blacklisted by the National Association of Securities Dealers; he had confessed to a bank fraud in Michigan and another fraud in California; and he had served three years in jail for a fraud-related crime." *Id*. at *9.

Although the investigator reported the results of his investigation to the FBI, he never shared that information with the Bank's account managers. *Id*. The Bank then asked a major accounting firm to verify the identities of C's customers. The accounting firm "reported that [C's] customers were real, although it later turned out that W 'had deceived [the accounting firm]' by providing it with fake responses from [C's] fake customers." *Id*. at *9-*10. Eventually, by Oct. 29, 2004, C had repaid its entire $16 million debt to the Bank. Later that year "the FBI raided [C's] offices," and W "committed suicide shortly thereafter." *Id*. at *10. C was later placed into bankruptcy by its creditors, and T by its court-appointed receiver.

The bankruptcy court "conducted two trials and issued multiple opinions" in the Trustee's litigation against the Bank to recover "all of the direct loan repayments, the indirect loan repayments, and the excess deposits" in C's bank accounts. *Id*. The bankruptcy court ultimately held the Bank liable for approximately $72 million, representing the loan repayments and excess deposits, plus prejudgment interest at the federal statutory rate for post-judgment interest. *Id*. at *14. Because the bankruptcy judge questioned his constitutional authority to enter a final judgment, he summarized his findings of facts and conclusion of law in a "Report and Recommendation." The district court's judgment affirmed the bankruptcy court, holding that the Trustee could recover all three types of transfers from the Bank. The Bank argued on appeal that it was "not a transferee of the excess deposits, and that it received the loan repayments in good faith." *Id*.

Analysis

T's Direct Loan Repayments

The Sixth Circuit accepted the lower court's finding "that a critical breakdown in [the Bank's] internal communications ended its proven good faith on April 30, 2004." *Id*. at *27. Thus, the trustee could recover "all subsequent loan repayments," including "some of the indirect loan repayments and all of the direct loan repayments" made after April 30, 2004. *Id*. at *27-*28.

> ***Although the investigator reported the results of his investigation to the FBI, he never shared that information with the Bank's account managers.***

The Court of Appeals also agreed that the Bank's "continued cooperation with the FBI did not cure the corporate bad faith embedded in [the Bank's] breakdown in communication … ." *Id*. at *30. In its view, the Bank's "good faith may end while its employees' good faith … continued" because "its [investigator] failed to share information … with the person whom [the Bank] charged with managing" its relationship with C. *Id*. at *31. The "innocent miscommunication" was immaterial, for the Bank was "ultimately responsible for the investigator's withholding from [the account manager] information that would have truly put [the manager] to the test." *Id*. As a result, the Trustee was able to recover "all direct loan repayments, of which [the Bank] is an initial transferee" because the Bank received them after April 30, 2004, when it could no longer claim good faith. *Id*. at *32. The trustee was also entitled to recover any indirect loan repayments where the Bank was a subsequent transferee after April 30, 2004. *Id*.

Next month, we will discuss the issues presented in *Meoli*, including the question of notice, the proper test of good faith, and an analysis of whether banks may be considered "transferees" with respect to ordinary bank deposits. In addition, we will discuss a recent Ninth Circuit preference decision that offers a mistaken analysis of the transfer issue.

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