ALERTS

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

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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.

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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 Seventh Circuit rejected a bank's good faith defense. The bank had lent approximately $300 million to a company that had capital equal to roughly 1/150 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 was on inquiry notice that the assets securing the loan had been fraudulently pledged to it. *Id.* at 966. Just three years ago, however, 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."). See also *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: (i) took the property "in good faith"; and (ii) "gave value to the debtor in exchange for such transfer." Code § 550(b)(1), in turn, provides that a

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subsequent transferee is not liable for the transferred property if it took the property: (i) "for value"; (ii) "in good faith"; and (iii) "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: (i) "direct loan repayments, which [T] sent directly to [the Bank] to pay down [C's] debt to [the Bank]; (ii) 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 (iii) 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

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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 pre-judgment 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.

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]

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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.*

Indirect Loan Repayments

Between Sept. 25, 2003 and April 30, 2004, the lower court found that the Bank acted in good faith prior to April 30, 2004, but still held the Bank liable because of its "inquiry notice of [C's] fraud on the earlier date." *Id.* at *32. It agreed with the Trustee that "inquiry notice constituted 'knowledge of the voidability of the transfers'" under Code §550(b)(1), eliminating the Bank's subsequent transferee defense. As noted above, however, the Sixth Circuit disagreed, explaining that "inquiry notice," by itself, "is not necessarily enough in every case." *Id.* at *33.

The court analyzed its two applicable precedents. *In re Nordic Village, Inc.,* 915 F.2d 1049, 1056 (6th Cir. 1990) (2-1), rev'd on other grounds, *U.S. v. Nordic Village*, *Inc.,* 503 U.S. 30 (1992) (on facts of that case, "inquiry notice" sufficed for "knowledge of the voidability"); *In re First Independence,* 181 App'x 524, 526 (th Cir. 2006) (fraudulent principals of debtor deposited checks into their personal accounts at defendant bank, giving bank "inquiry notice," but those facts "would not lead a reasonable person to believe that the transfers were voidable."). According to the court in *Nordic,* "the transferee failed to prove lack of knowledge of voidability because the facts would have 'placed a reasonable person on notice that the transfer was illegitimate, and by extension that it was voidable.'" *Id.* at *36. The IRS in *Nordic* had received a check from the corporate debtor who instructed it to "credit the payment against the outstanding tax liabilities of the delivering individual." *Id.* at *33, citing 915 F.3d at 1050-51. Because "it is not in an ordinary practice for corporate entities to pay one another's taxes, that irregularity was notice of

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voidability." *Id.* at *34, citing 915 F. 3d at 1056. In *First Independence,* however, the court held that although "inquiry notice sometimes suffices to 'alert' a reasonable person to voidability, … , on different facts [viewed] holistically, a reasonable person may not be alerted to a transfer's voidability even if there was inquiry notice … ." *Id.* There were at least two "legitimate scenarios" in *First Independence* that would eliminate "knowledge" of voidability: the checks could have been salary payments, and "any inquiry into the legitimacy of the checks would have been futile" for the debtor's principals would have been the only knowledgeable source. *Id.* at *34, citing 181 F. App'x at 529.

Test of Good Faith

The Sixth Circuit rejected the Trustee's challenge to the district court's analysis of the "good faith" requirement. Although the lower court had "struggled" to decide "whether the proper test is objective or subjective," it "concluded that the correct standard … is a 'subjective' test probing [the Bank's] 'integrity, trust and good conduct.' " *Id.* at *38. In fact, said the Sixth Circuit, "other courts have 'struggled' to define good faith in this context." *Id.* at *39, citing *First Independence,* 181 App'x at 524. In *First Independence,* "the court approved the bankruptcy court's determination of good faith when … the transferee did not have actual notice of the voidability of the transfers and did not undertake 'egregious, vindictive or intentional misconduct.'" *Id.* Here, the bankruptcy court asked whether the Bank "legitimately continued to believe that [T's] transfers to [C's] account were merely [C's] receivables that [T] had collected." *Id.* at *40. The question on remand, therefore, is simply whether the Bank eventually "gained knowledge of the voidability of the transfers [to it] before April 30, 2004." *Id.*

Transferee Analysis

The Court of Appeals held that the trustee could not "recover [C's] excess deposits (those deposits not applied to pay back debts to [the Bank])." As noted, "banks are not 'transferees' with respect to ordinary bank deposits" because they lack "dominion and control over them." Id. at *16, citing *In re Hurtado,* 342 F.3d 528, 533 (6th Cir. 2003); *Bonded Fin. Servs., Inc. v. European Am. Bank,* 838 F.2d 890, 893 (7th Cir. 1988). Other circuits have routinely applied this analysis: the account-holder's right to withdraw the deposits keeps the bank from obtaining dominion and control. Thus, when a bank provides "two services to a customer" – lending money and maintaining the customer's deposit account –the

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deposit account does not belong to the bank. It is "only when the customer instruct[s] the bank to use [the funds on deposit] to reduce its debt to the bank that the bank gains dominion over the money." *Id.* at *17. Accord, *In re Chase & Sanborn Corp.,* 848 F.2d 1196, 1200 (11th Cir. 1988); *In re Incomnet, Inc.,* 463 F.3d 1064, 1074 (9th Cir. 2006). In short, the depositor of the funds, not the bank, maintains dominion and control over its deposits. *Id.* at *20, citing *Hurtado,* 342 F.3d at 535. Thus, the Bank "did not become a transferee of [C's] deposits simply by maintaining [C's] deposit account." *Id.* at *21.

No Dominion and Control by Reason of Security Interest

The Trustee further argued that the Bank's perfected security interest in about $64 million of C's deposits gave it "dominion and control." *Id.* at *21. Rejecting the Trustee's "security interest theory," the Sixth Circuit reasoned that "a security interest cannot grant dominion over $48 million more than the underlying debt." *Id.* at *22. Here, the loan agreements explicitly provided that C "owned the deposits despite [the Bank's] security interest in them." *Id.* The law of secured transactions limits recovery upon default to the underlying debt. *Id.* at *22. Because C's underlying debt to the Bank was only $16 million, the Bank lacked "dominion and control over" the excess deposits. *Id.* at *23. The Bank's "rights' were limited to the amount of the [underlying] debt." *Id.* at *24. "In short, [C] retained dominion and control over its [excess] deposits despite [the Bank's] security interest in them, and [C] could use its money and other assets however it wanted to." *Id.* at *24-*25.

Meoli confirms the fact-intensive nature of "good faith" litigation in the fraudulent transfer context. After two trials and at least five bankruptcy court opinions between 2009 and 2012 covering events occurring between 2002 and 2004, the litigation still continues. A 45-page opinion from the Sixth Circuit in this case led a concurring judge to write two more pages stressing that "transferees" such as the Bank "are not required to undertake unduly onerous investigations, and that whether an investigation is unduly onerous depends on the circumstances of the case." *Id.* at *47. Citing other circuits, the concurring judge stressed that "[n]o one supposes that 'knowledge of voidability' means complete understanding of the facts and receipt of a lawyer's opinion that such a transfer is voidable; some lesser knowledge will do." *Id.* at *46, citing *In re Sherman,* 67 F. 3d 1348, 1357 (8thCir. 1995), quoting *Bonded Fin. Servs., Inc. v. European Am. Bank,* 838 F. 2d 890, 898 (7th Cir. 1988) (failure to

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make inquiry did not permit court to attribute to transferee knowledge of voidability of transaction; "'knowledge' is a stronger term than 'notice.' A transferee that lacks information necessary to support an inference of knowledge need not start investigating on his own"; bank knew nothing of debtor's "financial peril" and debt*or was not bank's "customer"; debtor had provided funds to its principal who repaid the bank).* See also *In re Bressman,* 327 F. 3d 229, 236-37 (3d Cir. 2003) (law firms took in "good faith" and for "value … without knowledge of voidability"; firms paid by debtor's wife who had received assets fraudulently).

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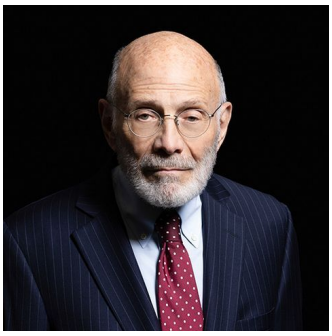

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