

# Client Alert

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## Good Faith Transferee in a Fraudulent Transfer Action can only Retain Transfers Equal to the Value It Provided to the Debtor

The United States Court of Appeals for the Fifth Circuit recently entered an order confirming that when a fraudulent transfer defendant is able to establish a defense pursuant to 11 U.S.C. § 548(c), the defendant is only able to retain the amount of the transfers equivalent to the value given to the debtor.<sup>1</sup> The measure of value must be considered from the transferee's perspective and if the value the transferee provides to the debtor is less than the amount of the transfers received, the court must net these amounts against each other to determine how much the transferee is required to return to the debtor's estate.<sup>2</sup>

### Case Background

Positive Health Management, Inc. ("PHM") operated pain management clinics in Texas. Ronald Ziegler ("Ziegler") was the president and sole shareholder of PHM.<sup>3</sup> In 2005, First National Bank ("First National") refinanced a loan (the "Garland Loan") it had made to Ziegler Enterprises II, LLC ("Ziegler Enterprises II"), which was owned by Ziegler; the Garland Loan was secured by a building in Garland, Texas that PHM used for its offices.<sup>4</sup>

From September 2006 to March 2008, PHM made payments totaling \$367,681.35 to First National despite the fact that Ziegler Enterprises II, not PHM, owed that obligation to First National under Garland Loan; however, PHM did use the office building secured by the Garland Loan for office space during the same period.<sup>5</sup> When PHM stopped making payments on the Garland Loan in March of 2008 First National foreclosed on the office building.<sup>6</sup>

PHM filed for voluntary protection under Chapter 11 of the United States Bankruptcy Code (the "Bankruptcy Code") on March 11, 2008 in the Southern District of Texas. The case was converted to a

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<sup>1</sup> *Williams v. FDIC (In the Matter of Positive Health Management)*, 769 F.3d 899 (5<sup>th</sup> Cir. 2014). Other Circuits have addressed the issue of whether netting is required when a recipient of a fraudulent transfer receives more from the debtor than the value it provided to the debtor and have also concluded that netting is necessary. See, *Clark v. Sec. Pac. Bus. Credit, Inc. (In re Wes Dor, Inc.)*, 996 F.2d 237, 243 (10<sup>th</sup> Cir. 1993); *Perkins v. Haines*, 661 F.3d 623,627 (11<sup>th</sup> Cir. 2011); *Donell v. Kowell*, 533 F.3d 762,770 (9<sup>th</sup> Cir. 2008).

<sup>2</sup> *Id.* at 904-09.

<sup>3</sup> *Id.* at 901-02.

<sup>4</sup> *Id.* at 902.

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

case under Chapter 7 of the Bankruptcy Code on March 13, 2009 and Randy Williams was appointed as the Chapter 7 Trustee of PMH (the "Trustee"). On March 9, 2010, the Trustee initiated an adversary proceeding under 11 U.S.C. § 548 against First National seeking to recover the \$367,681.35 in payments received by First National from PMH as fraudulent transfers.

### **Bankruptcy and District Court Decisions**

The Bankruptcy Court held a three day trial in the adversary proceeding on the Trustee's fraudulent transfer claims and submitted proposed findings of fact and conclusions of law to the United States District Court for the Southern District of Texas.<sup>7</sup>

The Bankruptcy Court determined that PMH received reasonably equivalent value for the \$367,681.35 it paid to First National, which accepted the transfers in good faith, and therefore, the Trustee could not succeed on his constructive fraudulent transfer claim.<sup>8</sup> The Bankruptcy Court concluded that First National's forbearance from foreclosing on the Garland office building allowed PMH to continue its operations and held, based on an appraisal conducted in 2006, that the reasonable rent for the office space for the time period at issue was \$253,333.33.<sup>9</sup>

The Trustee sought to recover the funds transferred from PMH to First National under an actual fraudulent transfer theory as well.<sup>10</sup> In analyzing whether PMH made the transfers to First National with the actual intent to hinder, delay or defraud its creditors, the Bankruptcy Court reviewed the "badges of fraud" present at the time of the transfers and focusing on PMH's deteriorating financial health and the multiple pending lawsuits and judgments against it at the time of the transfers, found that the transfers were made with the intent to hinder, defraud, or delay creditors of PMH.<sup>11</sup>

Although the Bankruptcy Court decided that the transfers from PHM to First National were actually fraudulent, the Bankruptcy Court held that First National established an affirmative defense under 11 U.S.C. § 548(c)<sup>12</sup> that it received the payments in good faith and gave value in return. Based on the affirmative defense under 548(c), the Bankruptcy Court concluded that First National was able to retain the transfers it received from PHM.<sup>13</sup>

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<sup>7</sup> *Id.*

<sup>8</sup> For a transfer to be constructively fraudulent, the debtor must have "(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and (ii) (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation; (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or (IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business." See 11 U.S.C. § 548(a)(1)(B).

<sup>9</sup> *Williams v. FDIC*, 769 F.3d at 902.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> Section 548(c) states, "[e]xcept to the extent that a transfer or obligation voidable under this section is voidable under section 544, 545, or 547 of this title, a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation." 11 U.S.C. §548(c).

<sup>13</sup> *Williams v. FDIC*, 769 F.3d at 902-03.

The District Court adopted the Bankruptcy Court's proposed order in connection with its findings of fact and conclusions of law.<sup>14</sup> Subsequently, the Trustee filed a motion to amend the judgment asserting that First National had not adequately pled its affirmative defense and that the testimony as to the market value of the office rent was unreliable.<sup>15</sup> The District Court referred the Trustee's motion to Bankruptcy Court.<sup>16</sup> The Bankruptcy Court held another hearing on First National's affirmative defense; at this hearing the Trustee challenged the market value of the rent presented by First National, but did not introduce evidence to support what believed the appropriate market rent was.<sup>17</sup> Consequently, the Bankruptcy Court reiterated its original recommendation, and the District Court adopted the Bankruptcy Court's recommendation.<sup>18</sup> The Trustee appealed the ruling to the Fifth Circuit Court of Appeals.<sup>19</sup>

### **Fifth Circuit Decision**

On appeal to the Fifth Circuit, the Trustee did not challenge that First National acted in good faith when it accepted the transfers from PMH, but sought review of whether First National provided value in exchange for the transfers.<sup>20</sup> The Trustee asserted that the Bankruptcy Court erred when it found that First National provided value based on the benefit received by PMH and also erred in accepting unreliable evidence of the value of the market rent of the office building.<sup>21</sup>

The Fifth Circuit, citing to its earlier decision in *Jimmy Swaggart Ministries v. Hayes (In re Hannover Corp.)*, 310 F.3d 796 (5<sup>th</sup> Cir. 2002), noted that "value" for a defense pursuant to section 548(c) must be measured from the transferee's perspective; whether the transferor received any actual value from the transfer is irrelevant.<sup>22</sup> Although the Bankruptcy Court determined that First National was entitled to a defense under section 548(c) based on the benefit received by PMH, a determination inconsistent with the Fifth Circuit's decision in *Hannover*, the Fifth Circuit concluded that the Bankruptcy Court was still correct in granting First National a defense under section 548(c) based on its alternative finding of value as a result of accepting loan payments from PMH in lieu of rental payments it could have received from a different potential tenant in the Garland office building.<sup>23</sup>

After determining that First National was entitled to a defense under section 548(c), the Fifth Circuit turned to the question of whether First National could retain the entire \$367,681.35 in transfers from PMH or whether it only was able to keep the market rent amount, \$253,333.33, and the Trustee should receive the difference of \$114,348.02.<sup>24</sup> The Trustee argued that, at minimum, the bankruptcy estate should

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<sup>14</sup> *Id.* at 903.

<sup>15</sup> *Id.* at 903.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> To receive the protection of section 548(c) of the Bankruptcy Code, the transferee must prove that it provided value in good faith in exchange for the transfers.

<sup>21</sup> *Williams v. FDIC*, 769 F.3d at 904.

<sup>22</sup> *Id.*

<sup>23</sup> *Id.* at 905.

<sup>24</sup> *Id.* at 906.

receive \$114,348.02 because section 548(c) provides that if a transferee can establish that it received a transfer in good faith, then it “may retain any interest transferred... *to the extent* that such transferee... gave value to the debtor in exchange for such transfer or obligation.”<sup>25</sup> First National countered that it was entitled to keep the entire amount of the transfers because the market rate for renting the office building was “reasonably equivalent” to the amount of the transfers it received; First National argued that it was inappropriate to undertake a dollar for dollar netting of the amount received against the value it provided.<sup>26</sup>

The Fifth Circuit noted that the concept of “reasonably equivalent value” appears in section 548(a)(1)(B)(i) as a factor to consider in analyzing whether a transfer was constructively fraudulent, but does not appear in section 548(c).<sup>27</sup> The Fifth Circuit found the exclusion of the phrase “reasonably equivalent value” from section 548(c) particularly significant in light of the fact that the Uniform Fraudulent Transfer Act provides a complete defense in its affirmative defense to fraudulent transfer claims where “reasonably equivalent value” is provided to the debtor.<sup>28</sup> Additionally, the Fifth Circuit held that “the last clause of [section 548(c)], beginning with ‘to the extent’ makes clear that a transferee is entitled to keep only the amount it gave up in exchange” and ultimately concluded “a good faith transferee is entitled to the protections of section 548(c) when it gives any value in return, but only to the extent of the value. When a transferee receives a fraudulent transfer the value of which exceeds the consideration it gave up in return section, 548(c) requires netting.”<sup>29</sup> As a result, the Fifth Circuit affirmed the District Court’s findings that the transfers were fraudulent under section 548(a)(1)(A), affirmed the District Court’s ruling that First National was entitled to a defense under section 548(c), but reversed the holding that First National was allowed to retain the entire transfer and instead, ordered First National to pay the sum of \$114,348.02 to the Trustee.<sup>30</sup>

## Conclusion

A party that receives pre-bankruptcy transfers from a debtor that may be avoided as a fraudulent transfer under section 548 will be able to prevent the debtor or trustee from recovering those transfers if the transferee can establish that it was a good faith transferee and provided value to the debtor. However, the Fifth Circuit’s holding in *Positive Health Management* should serve notice to transferees that when they receive transfers in excess of the value provided to the debtor the court will require a transferee to disgorge the difference between that amount it received and the value it provided.

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<sup>25</sup> 11 U.S.C. §548 (c) (emphasis added).

<sup>26</sup> *Williams v. FDIC*, 769 F.3d at 906-08.

<sup>27</sup> It is a well-accepted tenant that “when the legislature uses certain language in one part of the statute and different language in another, the court assumes different meanings were intended.” See *Sosa v. Alvarez-Machain*, 542 U.S. 692, 711 n. 9, 124 S.Ct. 2739, 159 LEd.2d 718 (2004).

<sup>28</sup> *Williams v. FDIC*, 769 F.3d at 907.

<sup>29</sup> *Id.* at 907-09.

<sup>30</sup> *Id.* at 909.

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