Debt Repayments as Fraudulent Transfers

by

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INTRODUCTION

Preference law and fraudulent transfer law have different purposes and address different problems. The basic object of preference law is to promote "equality of distribution among creditors of the debtor."[1] By contrast, "[t]he basic object of fraudulent conveyance law is to see that the debtor uses his limited assets to satisfy *some* of his creditors; it normally does not try to choose among them."[2] Although both bodies of law permit challenges to and recovery of transfers considered detrimental to creditors, preference law is focused on transfers that benefit some creditors over others, whereas fraudulent transfer law is generally focused on transfers that "reduce the value of the debtor's estate and thus the net return to creditors *as a group*."[3]

The question explored here is whether debt repayments, which fall squarely within the province of preference law, may in some circumstances be avoided as fraudulent transfers. Elementary as it seems, this question has been lurking in the law for a long time. In *Dean v. Davis*, decided in 1917, the United States Supreme Court spoke directly to the issue, stating in *dicta* that "[a] transaction may be invalid *both* as a preference *and* as a fraudulent transfer."[4] Yet in his authoritative treatise published in 1940, Professor Garrard Glenn declared that "[i]f there is in our law one point which is more ungrudgingly accepted than others, it is that the preferential transfer does *not* constitute a fraudulent conveyance."[5] More recently, in a widely cited case, the Court of Appeals for the Second Circuit observed that "[a] conveyance which satisfies an antecedent debt made while the debtor is insolvent is neither fraudulent nor otherwise improper, even if its effect is to prefer one creditor over another."[6]

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[1]*E.g.*, Lawson v. Ford Motor Co. (*In re* Roblin Indus., Inc.), 78 F.3d 30, 40 (2d Cir. 1996) (quoting H.R. 595, 95th Cong. 177-78 (1st Sess. 1977)).

[2]Boston Trading Grp., Inc. v. Burnazos, 835 F.2d 1504, 1509 (1st Cir. 1987) (Breyer, J.); *accord* Note, *Good Faith and Fraudulent Conveyances*, 97 HARV. L. REV. 495, 502-03 (1984) ("Fraudulent conveyance law is intended to ensure only that *some* deserving creditor receives the debtor's reachable assets.").

[3]Bonded Fin. Servs., Inc. v. European Am. Bank, 838 F.2d 890, 892 (7th Cir. 1988) (emphasis added) (Easterbrook, J.).

[4]Dean v. Davis, 242 U.S. 438, 444 (1917) (emphasis added); *see also* Richardson v. Germania Bank of City of N.Y., 263 F. 320, 323-24 (2d Cir. 1919) (interpreting the *Dean* decision as correcting "pen slips" in previous court opinions that could "be read as meaning that a preferential transfer cannot be a fraudulent conveyance"). For further discussion of *Dean*, *see infra* note 127 and surrounding text, and *infra* note 134.

[5]1 GARRARD GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES § 289, at 488 (rev. ed. 1940) (emphasis added); *see also* Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 714 (1985) ("The concept of a voidable fraudulent conveyance outside of bankruptcy . . . never embraced the concept of voidable preference."). The terms "fraudulent transfer" and "fraudulent conveyance" are used interchangeably in this article. The Bankruptcy Code, along with more recently enacted state statutes, uses the term "transfer" rather than "conveyance."

[6]Sharp Int'l Corp. v. State St. Bank & Trust Co. (*In re* Sharp Int'l Corp.), 403 F.3d 43, 54-55 (2d Cir. 2005) (quoting Ultramar Energy, Ltd. v. Chase Manhattan Bank, N.A., 191 A.D.2d 86, 90-91 (N.Y. App. Div. 1993)).

Whether there is, or should be, a bright line separating preferential and fraudulent transfers is an important question. Fraudulent transfer law is in many ways a more potent tool than preference law. Under the Bankruptcy Code, a transfer can be avoided as a preference only if it took place within ninety days before the debtor's bankruptcy petition (or one year where the defendant is an insider of the debtor).[7] Fraudulent transfer law, by contrast, can reach back far longer—four years in most states[8] and up to six years in other states, including New York.[9] Moreover, preference claims and fraudulent transfer claims are subject to different defenses. For example, preference claims are subject to an "ordinary course of business" defense and a "contemporaneous exchange for new value" defense.[10] Preference claims also are subject to the Bankruptcy Code's "safe harbor" provisions, which broadly protect financial market transactions from avoidance, whereas claims of intentional fraudulent transfer under the Bankruptcy Code are not.[11] As a result of these and other differences between preference and fraudulent transfer claims, a rule that shields debt repayments from attack on fraudulent transfer grounds would have significant implications, including limiting the time period in which debt repayments may be challenged.

Recent cases have highlighted the question whether debt repayments (or liens to secure existing debts) can be avoided as fraudulent transfers. For example, in several large Ponzi-scheme cases, courts have held that the repayment of principal to a defrauded investor may be challenged as an intentional fraudulent transfer, even though such a payment satisfies a debt—namely, the restitution claim resulting from the debtor's fraud.[12] In other noteworthy cases, courts have sustained fraudulent transfer challenges to large restructuring transactions, even where the transactions involved securing or paying

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[7] 11 U.S.C. § 547(b). Some state statutes governing collective insolvency proceedings similarly provide for the avoidance of preferential transfers, but typically do not reach as far back in time as fraudulent transfer provisions. *See, e.g.*, N.Y. DEBT. & CRED. LAW § 15(6-a) (McKinney 2001) (where debtor makes general assignment for the benefit of creditors, assignee can reach preferential transfers that took place four months before the assignment); CAL. CIV. PROC. § 1800(b) (West 2007) (same, but with ninety-day look-back period).

[8] *See* Uniform Fraudulent Transfer Act ("UFTA") § 9 (1984) (most fraudulent transfer claims extinguished unless brought within four years of the transfer).

[9] *See, e.g.*, Picard v. Katz, 462 B.R. 447, 451 (S.D.N.Y. 2011) (under New York law, "fraudulent transfers can be avoided if they occurred within 6 years of the filing" (citing N.Y. C.P.L.R. 213(8) (McKinney 2001)); Wall St. Assocs. v. Brodsky, 257 A.D.2d 526, 530 (N.Y. App. Div. 1999) (six-year period under New York law).

[10] 11 U.S.C. § 547(c).

[11] 11 U.S.C. § 546(e)-(g) (excluding claims for actual-intent fraudulent transfer under § 548(a)(1)).

[12] *See, e.g.*, Gowan v. Patriot Grp., LLC (*In re* Dreier LLP), 452 B.R. 391, 425 (Bankr. S.D.N.Y. 2011) (rejecting argument that debt repayments by Ponzi scheme operator could not be avoided as intentional fraudulent transfers, although dismissing claims seeking avoidance of such repayments as constructive fraudulent transfers); *see also Picard*, 462 B.R. at 453-54 (similar ruling with respect to intentional fraudulent transfer claims).

down debt.[13]

This article considers the application of fraudulent transfer law to debt repayments. To lay the groundwork, we provide in Part I an overview of the federal and state statutes governing fraudulent transfers and preferences. We then discuss in Part II the case law dealing with challenges to debt repayments as fraudulent transfers. We show that, in a broad array of cases, courts applying both the Bankruptcy Code and state law have shielded debt repayments to non-insiders from claims of *constructive* fraudulent transfer. Claims of *intentional* fraudulent transfer have posed more difficulty because, under the governing statutes, they do not explicitly depend on the value received by a debtor in exchange for a challenged transfer. Although the cases have diverged to some extent, a principle that emerges from a long line of decisions is that a debtor's intent to "prefer" one creditor over another is fundamentally different from the intent to "hinder, delay, or defraud" that is required by the fraudulent transfer statutes. As a result, other than in rare situations, such as those involving Ponzi schemes—in which preferential debt repayments are an integral part of a broader scheme to benefit the debtor or its owners at the expense of creditors—such debt repayments generally have not been avoided as intentional fraudulent transfers. This is true despite the fact that preferential debt repayments by an insolvent borrower will inevitably have the incidental effect of reducing the recoveries of other creditors.

While the focus of Part II is on the question of when a debtor can be said to have defrauded creditors by paying back some but not others, in Part III we consider the circumstances in which the repaid creditor is sufficiently culpable that it must return a fraudulent debt repayment. In particular, we discuss the role of the affirmative defense to fraudulent transfer claims that is available to defendants that provide "value" in exchange for a transfer, including by discharging or securing an antecedent debt, in "good faith." We conclude that, although the good faith defense has functioned to some degree as a safeguard against the incursion of fraudulent transfer law into the traditional domain of preference law, the wide-scale adoption of an objective definition of good faith—which focuses on the defendants' "inquiry notice" and diligence—has created substantial uncertainty. Against that backdrop, we advocate for a subjective good faith test that focuses on a creditor-defendant's state of mind. Although such a test is not easily formulated and has not been fully developed in the case law, it presents a more coherent alternative that is

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[13]Official Comm. of Unsecured Creditors v. Citicorp N. Am. (*In re* TOUSA, Inc.), 422 B.R. 783 (Bankr. S.D. Fla. 2009) (transfer of liens to creditors of the debtors' parent company avoided as constructively fraudulent), *rev'd*, 444 B.R. 613 (S.D. Fla. 2011), *reinstated*, Citicorp N. Am., Inc. v. Official Comm. of Unsecured Creditors (*In re* TOUSA, Inc.), 680 F.3d 1298 (11th Cir. 2012); ASARCO LLC v. Ams. Mining Corp., 396 B.R. 278, 389 (S.D. Tex. 2008) (transaction involving asset sale where proceeds were used to repay some creditors avoided as intentionally fraudulent).

supported by statutory language and the policies of fraudulent transfer law, as opposed to those of preference law.

I. LEGAL BACKGROUND: FRAUDULENT TRANSFERS AND PREFERENCES

A. The development of fraudulent transfer law

Fraudulent transfer law traces its history to at least the sixteenth century, with the 1571 enactment by the English Parliament of the Statute of 13 Elizabeth. That statute prohibited transfers made to "delay, hinder or defraud" creditors, and punished the parties to such transfers, except for transferees for "good consideration and *bona fide*."[14] Although the statute originally was intended as a revenue-raising mechanism for the English crown—providing that half of any property transferred in violation of the statute was to be forfeited to the sovereign, with the other half going to the "party or parties grieved"—it was not long until the statute evolved to protect creditor rights more broadly.[15] In 1603, English law was amended to provide that fraudulently conveyed assets would be made available to a bankrupt debtor's estate.[16]

The injury that fraudulent transfer law is meant to prevent has been identified as the unfair "diminution" of the property available to satisfy creditor claims[17]—"putting realizable assets beyond the reach of the creditor's process, whatever form that process may take."[18] Like modern statutes, however, the early statutes barring fraudulent transfers spoke in terms of the debtor's "intent," which can be difficult to prove. Thus, common law judges developed factors, known as "badges of fraud," that may be considered in determining whether the debtor acted with fraudulent intent, even where "no specific evidence suggested that the debtor tried to profit at his creditors' expense."[19] *Twyne's Case*, an early decision interpreting the Statute of Elizabeth, is a prime example: Pierce, a farmer, was sued by a creditor on a debt. While a writ of execution was pending, Pierce transferred his sheep to Twyne to pay off another debt, but remained in possession of the flock. The court concluded that a fraudulent conveyance had occurred, relying on several badges of fraud, including that Pierce's gift to Twyne had been made in secret, that it had been made in the face of a pending writ of execution, and

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[14] 13 Eliz., ch. 5 (1571); *see* Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 829 (1985) (discussing the statute).

[15] *See generally* 1 GLENN, *supra* note 5, § 61a-e (discussing history of Statute of Elizabeth).

[16] *Id.* § 61e.

[17] *See, e.g.*, *id.* § 195 ("The real test of a fraudulent conveyance . . . is the unjust diminution of the debtor's estate.").

[18] *Id.* § 1.

[19] Baird & Jackson, *supra* note 14, at 830.

that Pierce had remained in possession of the sheep.[20]

Over the centuries, the "badges of fraud" came to be codified in statutes. The Uniform Fraudulent Transfer Act ("UFTA"), which has been adopted by most states, identifies eleven "factors" to which "consideration may be given" in "determining actual intent."[21] These include, among others, the badges of fraud identified in *Twyne's Case*, such as concealment of the transfer, pendency of a lawsuit, and retention of control by the debtor over the transferred assets.[22] They also include the debtor's insolvency at the time of the transfer and the debtor's receipt of too little consideration in return for the transfer.[23]

These last two badges of fraud—the debtor's insolvency and lack of adequate consideration—came to have unique significance. The beginning of the twentieth century saw legislative efforts to give creditors "the power to avoid transactions regardless of the transferor's intent" when those transfers were "deemed to diminish unfairly a debtor's assets in derogation of creditors."[24] Insolvency and lack of fair value, when proven together, were determined by the legislatures to indicate such unfair diminution. Thus, under modern statutes, they serve not just as potential indirect evidence of improper intent, but also as independently sufficient grounds to avoid a transfer, even where malicious intent by the debtor is not proven.[25] Transfers that are avoided based on the debtor's insolvency (broadly defined) and lack of adequate value[26] are referred to as "constructively fraudulent."

B. Statutory treatment of fraudulent transfers

Fraudulent transfer litigation often takes place in the context of a bank-

[20]Twyne's Case, (1601) 76 Eng. Rep. 809, 810-11 (K.B.).

[21]These include: (1) the transfer or obligation was to an insider; (2) the debtor retained possession or control of the property transferred after the transfer; (3) the transfer or obligation was not disclosed or concealed; (4) before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit; (5) the transfer was of substantially all the debtor's assets; (6) the debtor absconded; (7) the debtor removed or concealed assets; (8) the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred; (9) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred; (10) the transfer occurred shortly before or shortly after a substantial debt was incurred; and (11) the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor. UFTA § 4(b) (1984). This list "includes most of the badges of fraud that have been recognized by courts," *id.* § 4, cmt. 5, and has often been considered by courts in applying section 548(a)(1) of the Bankruptcy Code. *See* 5 Collier on Bankruptcy ¶ 548.04[1][b][i] (Alan Resnick & Henry Sommer eds., 16th ed. 2013); *see also* Max Sugarman Funeral Home, Inc. v. A.D.B. Investors, 926 F.2d 1248, 1254 (1st Cir. 1991) (listing numerous badges of fraud in assessing claim under section 548).

[22]UFTA § 4(b).

[23]*Id.*

[24]5 Collier on Bankruptcy ¶ 548.05[1] (Alan Resnick & Henry Sommer eds., 16th ed. 2013).

[25]Baird & Jackson, *supra* note 14, at 830.

[26]*E.g.*, UFTA § 5(a) (1984); 11 U.S.C. § 548(a)(1)(B).

ruptcy case through the commencement of an adversary proceeding. Section 548 of the Bankruptcy Code permits a bankruptcy trustee (or the debtor, in the absence of a trustee)[27] to avoid transfers made or obligations incurred by the debtor within two years before the filing of the bankruptcy, if the debtor "made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud" creditors.[28] The statute also permits a trustee to avoid a transfer or obligation that is constructively fraudulent, which under the Bankruptcy Code means the debtor "received less than a reasonably equivalent value in exchange" and the debtor's financial condition at the time met one of three tests: (i) the debtor was or was rendered balance-sheet insolvent, meaning its debts exceeded the fair value of its assets; (ii) the debtor was left with unreasonably small capital; or (iii) the debtor intended to incur, or believed that it would incur, debts beyond its ability to pay as they matured.[29]

Fraudulent transfer claims also can be pursued under state law. Outside of bankruptcy, a cause of action for fraudulent transfer under state law belongs to creditors injured by the transaction. In a bankruptcy case, the trustee may invoke section 544(b) of the Bankruptcy Code, which permits a trustee to avoid a transfer or obligation of the debtor "that is voidable under applicable law" by a creditor holding a valid unsecured claim against the estate.[30] In other words, if the trustee can identify a "golden creditor" that has the power under state law to avoid a transfer, the trustee can stand in the shoes of that creditor and pursue that creditor's claims.

State-law claims brought by a trustee in bankruptcy can have a greater effect than outside of bankruptcy: whereas state-law statutes typically permit a creditor to obtain "avoidance of the transfer or obligation to the extent necessary to satisfy the creditor's claim,"[31] the Bankruptcy Code permits the trustee to recover the property transferred, or the value thereof, "for the benefit of the estate."[32] Under longstanding case law, this generally means that the trustee can recover the entirety of an avoidable transfer and dis-

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[27]In chapter 11 cases where no trustee is appointed, the Bankruptcy Code gives a debtor in possession most of the same powers as a trustee, including the right to bring avoidance claims on behalf of the estate. 11 U.S.C. § 1107. Courts also may grant "derivative standing" to a creditors' committee to pursue avoidance actions on behalf of the estate where the debtor or trustee consents, or unreasonably fails to pursue such claims. *See* Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548, 579 (3d Cir. 2003); Commodore Int'l Ltd. v. Gould (*In re* Commodore Int'l Ltd.), 262 F.3d 96, 100 (2d Cir. 2001).

[28]11 U.S.C. § 548(a)(1)(A).

[29]*Id.* §§ 548(a)(1)(B), 101(32).

[30]*Id.* § 544(b).

[31]UFTA § 7 (1984); *see also* N.Y. DEBT. & CRED. LAW § 278(1)(a) (McKinney 2001) (permitting creditor to "[h]ave the conveyance set aside or obligation annulled to the extent necessary to satisfy his claim").

[32]11 U.S.C. § 550(a).

tribute that recovery to satisfy all allowed claims of creditors, including creditors who were not themselves eligible to recover the transfer at issue.[33] The avoidance power granted to the trustee under section 544(b) of the Bankruptcy Code can also exceed the power granted under section 548: since state laws typically have longer look-back periods than the two years provided by section 548,[34] a trustee can reach older transfers by suing under state law than by proceeding under section 548 alone.

Most states have adopted the UFTA, which bears a strong resemblance to section 548 of the Bankruptcy Code. Like its federal counterpart, the UFTA permits the avoidance of both actual-intent fraudulent transfers and constructive fraudulent transfers, which are those made for less than "reasonably equivalent value" when the debtor was insolvent, undercapitalized, or believed it would incur debts beyond its ability to pay.[35]

One notable jurisdiction that has not adopted the UFTA is New York, the location of many significant transactions and thus a state whose law governs many fraudulent transfer actions. New York's Debtor & Creditor Law ("DCL") is derived from the UFTA's predecessor, the Uniform Fraudulent Conveyance Act ("UFCA").[36] It is similar in many ways to the UFTA, but not in all respects. Most importantly for this article, under the DCL, constructive fraudulent conveyances are transfers made by an insolvent or undercapitalized debtor for less than "fair consideration."[37] That term is not perfectly synonymous with "reasonably equivalent value"; rather, it is defined to mean a "fair equivalent" given "in good faith."[38] The New York statute thus could be read to permit the avoidance of a transfer as constructively fraudulent even if the debtor received sufficient value, so long as that value was not provided by the transferee in "good faith."

An important defense to fraudulent transfer claims, under the Bankruptcy Code as well as state law, is the so-called "good faith" defense. In actions pursued under section 548, a transferee or obligee "that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred . . . to the extent that such transferee or obligee gave

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[33]*E.g.*, Acequia, Inc. v. Clinton (*In re* Acequia, Inc.), 34 F.3d 800, 808-12 (9th Cir. 1994). The doctrine that a trustee may avoid a transfer in its entirety, for the benefit of all creditors, dates back to the Supreme Court's decision in *Moore v. Bay*, 284 U.S. 4 (1931).

[34]*E.g.*, UFTA § 9 (1984) (providing for four-year statute of repose); N.Y. C.P.L.R. 213(8) (McKinney 2004) (providing for a six-year statute of limitations for "an action based upon fraud").

[35]UFTA § 5 (1984).

[36]The UFCA, introduced in 1918, was the law of twenty-three states at the height of its adoption. Following the 1984 promulgation of the UFTA, only New York and Maryland maintained the old uniform act. Forty-three states have enacted the UFTA; the remaining five states (Alaska, Kentucky, Louisiana, South Carolina and Virginia) employ their own statutory schemes. 5 COLLIER ON BANKRUPTCY ¶¶ 544.06[2], 548.01[2][a] (Alan Resnick & Henry Sommer eds., 16th ed. 2013).

[37]N.Y. DEBT. & CRED. LAW §§ 273-275 (McKinney 2001).

[38]*Id.* § 272.

value to the debtor in exchange for such transfer or obligation."[39] State-law statutes provide a similar defense: under the UFTA, an intentionally fraudulent transfer is not voidable "against a person who took in good faith and for a reasonably equivalent value"[40]; and regardless of whether the plaintiff recovers a transfer as intentionally or as constructively fraudulent, a "good-faith transferee or obligee is entitled, to the extent of the value given the debtor," to a lien on or the retention of the transferred property, enforcement of the obligation, or a reduction in liability.[41] New York's DCL similarly provides that a "purchaser who without actual fraudulent intent has given less than a fair consideration for the conveyance or obligation, may retain the property or obligation as security for repayment."[42] It also provides that a creditor may not proceed against "a purchaser for fair consideration without knowledge of the fraud at the time of the purchase."[43] In sum, under both the Bankruptcy Code and state law, a defendant that gives "value" in exchange for a challenged transfer or obligation will generally be protected from liability, up to the amount of value given, if it acted in "good faith," even when the *transferor* is shown to have acted with the intent to hinder, delay, or defraud creditors.[44]

In the context of a bankruptcy case, another important defense to fraudulent transfer liability arises under the "safe harbors" of section 546(e)-(g) of the Bankruptcy Code. Those sections broadly protect transfers made in connection with specified financial contracts (such as securities, swap, and repurchase agreements), except where such transfers can be avoided under the Bankruptcy Code's actual-intent fraudulent transfer provision.[45] The safe harbors, where applicable, thus prohibit an estate representative from relying on the Bankruptcy Code's constructive fraudulent transfer provision or on fraudulent transfer provisions in state law, including any look-back period longer than the two-year timeframe in section 548 of the Bankruptcy Code.

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[39] 11 U.S.C. § 548(c).

[40] UFTA § 8(a) (1984).

[41] *Id.* § 8(d).

[42] N.Y. DEBT. & CRED. LAW § 278(2) (McKinney 2001).

[43] *Id.* § 278(1).

[44] Where the initial recipient of a fraudulent transfer conveys the property to another, the subsequent transferee is provided with a similar defense under the Bankruptcy Code and the UFTA. *See* 11 U.S.C. § 550(b) (protecting a subsequent transferee that "takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided"); UFTA § 8(b) (protecting "a good faith transferee or obligee who took for value"). New York law exempts from liability any "purchaser for fair consideration without knowledge of the fraud at the time of the purchase," which includes subsequent transferees. N.Y. DEBT. & CRED. LAW § 278(1); *see* City of New York v. Johnson, 137 F.2d 163 (2d Cir. 1943) (execution creditor of transferee that attached proceeds of fraudulent transfer to satisfy debt was a "purchaser for fair consideration" protected by DCL § 278).

[45] 11 U.S.C. § 546(e)-(g).

But the safe harbors do not protect intentional fraudulent transfers that occurred within two years of the petition date.[46]

C. Statutory treatment of preferential transfers

A preference is a transfer by an insolvent debtor to pay or secure an antecedent debt—an act that has the effect of providing a greater recovery to one creditor than others similarly situated. As the Supreme Court commented over 100 years ago, while an actual-intent fraudulent transfer is "inherently and always vicious"—and thus *malum per se*—a preferential transfer is "innocent and valid, except when made in violation of the express provisions of a statute"—that is, merely *malum prohibitum*.[47] In addition, despite a long history of statutes that prohibited only preferential transfers that were "intentional," "fraudulent," or received by the transferee with knowledge of the debtor's insolvency,[48] preference law today is typically indifferent to the states of mind of the parties involved, focusing instead on the effects of the transfer.[49] The aim of preference law is twofold: it discourages creditors from "racing to the courthouse to dismember the debtor during his slide into bankruptcy," and it "facilitate[s] the prime bankruptcy policy of equality of distribution among creditors of the debtor. Any creditor that received a greater payment than others of his class is required to disgorge so that all may share equally."[50]

Unlike fraudulent transfers, which can be challenged by individual creditors outside of bankruptcy, preferential transfers for the most part cannot be pursued outside of a collective insolvency proceeding. As Professor Glenn

[46]Where state-law fraudulent transfer claims are abandoned by a bankruptcy estate and are then brought by individual creditors, the section 546 safe harbors may be held to preempt those claims, even though they are not being asserted by the estate. *See* Whyte v. Barclays Bank Plc, No. 12 Civ. 5318, 2013 WL 2489925 (S.D.N.Y. June 11, 2013); *but see In re* Tribune Co. Fraudulent Conveyance Litig., 499 B.R. 310 (S.D.N.Y. 2013) (concluding that fraudulent transfer claims abandoned by the estate and brought by individual creditors were not preempted); Weisfelner v. Fund 1 (*In re* Lyondell Chem. Co.), 503 B.R. 348 (Bankr. S.D.N.Y. 2014) (same). At present, the applicability of the safe harbors to claims pursued by individual creditors in lieu of a bankruptcy estate is an open question that is beyond the scope of this article.

[47]Van Iderstine v. Nat'l Disc. Co., 227 U.S. 575, 582 (1913).

[48]*See* 2 Glenn, *supra* note 5, §§ 378-80 (discussing history of preference law).

[49]*See* 5 Collier on Bankruptcy ¶ 547.01 (Alan Resnick & Henry Sommer eds., 16th ed. 2013) ("The debtor's intent or motive is not material in the consideration of an alleged preference under section 547."); *see also* Union Bank v. Wolas, 502 U.S. 151, 159 (1991) (recognizing that Bankruptcy Act preference provision required the transferee to have "reasonable cause to believe that the debtor [was] insolvent," but that the 1978 Bankruptcy Code "substantially enlarged the trustee's power to avoid preferential transfers by eliminating the reasonable cause to believe requirement for transfers made within 90 days of bankruptcy and creating a presumption of insolvency during that period"). For an in-depth treatment of the history and development of preference law through enactment of the Bankruptcy Code in 1978, *see* Countryman, *supra* note 5.

[50]Union Bank v. Wolas, 502 U.S. at 161; *see also* 2 Glenn, *supra* note 5, § 376 ("The preference violates the principle that there should be equal distribution when an estate is in liquidation.").

explained, to allow a lone creditor, "acting in his own interest, to set aside a preferential transfer would simply amount to substituting him as the party preferred."[51]

Preferences are primarily governed by section 547 of the Bankruptcy Code. That provision permits the trustee to "avoid any transfer of an interest of the debtor in property" that was made: (i) to or for the benefit of a creditor, (ii) for or on account of an antecedent debt, (iii) while the debtor was insolvent, (iv) within ninety days before the filing of the bankruptcy (or within one year, if the creditor was an insider), (v) such that the creditor was enabled to receive more on account of its claim than if the transfer had not been made.[52] For purposes of section 547, the debtor is presumed to have been insolvent during the ninety-day period leading up to the petition date.[53] In light of the requirement that a preferential transfer enable a creditor to receive more than it would receive in a liquidation, repayments of fully secured debt are generally protected from preference claims under the Bankruptcy Code.[54]

State law also contemplates the avoidance of preferential transfers. As discussed in more detail below, many states have incorporated into their fraudulent transfer law a doctrine that permits avoidance by creditors of preferential transfers to insiders.[55] Some state laws go further, establishing collective insolvency proceedings through which a representative of the debtor's creditors, as part of the restructuring of the debtor's obligations, is authorized to avoid preferential transfers. For instance, the New York DCL establishes a regime through which a debtor can make a general assignment for creditors, and empowers the assignee (analogous to a trustee in bankruptcy) to recover transfers by the debtor that were made (i) for or on account of an antecedent

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[51] 1 GLENN, *supra* note 5, § 289; *see also* Smith v. Whitman, 189 A.2d 15, 18 (N.J. 1963) ("True, a creditor who collects from an insolvent debtor fares better than other claimants. Yet if the transfer were set aside in favor of another creditor, there would be but a substitution of one preference for another."). Excepted from this rule are preferential payments to insiders of the debtor, which may be avoidable as fraudulent transfers under state law, as discussed in more detail below.

[52] 11 U.S.C. § 547(b). Some case law suggests that a preference claim requires a showing of "diminution" of the estate. *E.g.*, Harrison v. Brent Towing Co. (*In re* H&S Transp. Co.), 110 B.R. 827, 833 (Bankr. M.D. Tenn. 1990). But this concept has a different meaning in the preference context than in the fraudulent conveyance context. Under fraudulent transfer law, "diminution" refers to the shrinking of the size of the debtor's estate as a whole; under preference law, it means the shrinking of each non-preferred creditor's pro rata share compared to that of a preferred creditor's share. This latter notion of "diminution" is implied by the requirement of section 547 that there must be a transfer of debtor property that allows the transferee to receive more on account of its claim than it would in a liquidation proceeding. *See* Countryman, *supra* note 5, at 739-40.

[53] 11 U.S.C. § 547(f).

[54] *See, e.g.*, Schwinn Plan Comm. v. Transamerica Ins. Fin. Corp. (*In re* Schwinn Bicycle Co.), 200 B.R. 980, 988 (Bankr. N.D. Ill. 1996) (transfers to a fully secured creditor do not allow that creditor to receive more than in a liquidation, and thus do not "deplete" the estate for purposes of preference law).

[55] *See, e.g.*, UFTA § 5(b); *infra* Part II.A.2.

debt, (ii) to a creditor with "reasonable cause to believe" the debtor was insolvent, (iii) within four months of the general assignment, (iv) with the effect of enabling the creditor to "obtain a greater percentage of his debt than some other creditor of the same class."[56]

The viability of such state-law preference statutes is open to question. A divided panel of the Ninth Circuit Court of Appeals has held that the Bankruptcy Code preempts the preference provision in California's statutory scheme for general assignments. As the majority stated, "[w]e believe that statutes that give state assignees or trustees avoidance powers beyond those that may be exercised by individual creditors trench too close upon the exercise of the federal bankruptcy power."[57] The Ninth Circuit's holding has not been universally followed and has garnered criticism.[58] In any event, notwithstanding the existence of state-law preference provisions, most preference litigation arises under section 547 of the Bankruptcy Code.

Preference claims under the Bankruptcy Code are subject to various defenses, which are broadly in line with the goals of preference law. The statute provides a defense, for example, where the transferee extends new value to the debtor, either contemporaneously with the transfer or after the fact.[59] The "new value" defenses are designed to encourage creditors to continue dealing with troubled debtors without fear that they will have to disgorge payments received for valuable services or new financing. Another defense exists to protect repayments of debts incurred in the ordinary course of the debtor's business, where the repayments also are made in the ordinary course, or at least according to ordinary business terms[60]—that is, where there was no "unusual action by either the debtor or his creditors" of the type preference law is designed to discourage.[61] Other statutory defenses to preference

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[56] N.Y. DEBT. & CRED. LAW § 15(6-a) (McKinney 2001); *accord, e.g.*, WIS. STAT. ANN. § 128.07 (West 2009) (similar); CAL. CIV. PROC. § 1800(b) (West 2007) (similar, with ninety-day look-back period).

[57] Sherwood Partners, Inc. v. Lycos, Inc., 394 F.3d 1198, 1205 (9th Cir. 2005).

[58] *See, e.g.*, Ready Fixtures Co. v. Stevens Cabinets, 488 F. Supp. 2d 787, 792 (W.D. Wis. 2007) (declining to find preference provision in Wisconsin's general-assignment regime preempted, and enumerating criticisms of *Sherwood*). In addition, regardless of whether *Sherwood* is followed by other courts, it is not clear that the preemption principles on which it relies would restrict state-law avoidance of preferential transfers by debtors that are not eligible to file federal bankruptcy petitions. Insurance companies, for example, are not permitted to be "debtors" under the Bankruptcy Code (11 U.S.C. § 109(b)(2)), but the restructuring of their debts can occur under state-law rehabilitation regimes that include their own preference-avoidance provisions. *See, e.g.*, N.Y. INS. LAW § 7425 (McKinney 2001) (permitting rehabilitator of insurance company to avoid preferential transfers made within twelve months before the commencement of rehabilitation proceedings).

[59] *See* 11 U.S.C. § 547(c)(1), (c)(4).

[60] *Id.* § 547(c)(2).

[61] 5 COLLIER ON BANKRUPTCY ¶ 547.04[2] (Alan Resnick & Henry Sommer eds., 16th ed. 2013) (quoting H.R. REP. NO. 95-595, at 373-74 (1997), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6329).

claims are also available,[62] including under the safe-harbor provisions of section 546(e)-(g), which provide a bar to preference avoidance where the transfer involved a protected financial contract and a protected financial-industry participant.[63]

II. THE ELEMENTS OF A FRAUDULENT TRANSFER CLAIM APPLIED TO DEBT REPAYMENTS

The question whether a debt repayment may be recovered as a fraudulent transfer necessarily breaks down into two parts. First, all fraudulent transfer claims require a *prima facie* showing that the essential elements of the claim are met—i.e., under the constructive fraud provisions, that the debtor was insolvent or undercapitalized and received inadequate value; and under the actual-intent provisions, that the debtor intended to hinder, delay, or defraud creditors. Second, as discussed above, fraudulent transfer law provides a defense to liability to the extent a transferee gives value in good faith. That affirmative defense raises the separate question of when a preferred creditor should be deemed sufficiently culpable that it must disgorge what it received. This section focuses on the first issue: under what circumstances can it be shown that a debtor's conduct in repaying (or securing) a debt is sufficient to satisfy the elements of a fraudulent transfer claim?

A. Constructive fraudulent transfer

1. *The general rule protecting debt repayments from constructive fraudulent transfer claims*

The statutory architecture of the Bankruptcy Code, and of state statutes, suggests a dichotomy between a preferential debt repayment and a constructive fraudulent transfer. A preference is, by definition, a transfer that satisfies or secures an existing debt; a constructive fraudulent transfer is, by definition, made in exchange for insufficient value. Both the Bankruptcy Code and the UFTA define "value" to include the repayment or the securing of an antecedent debt.[64] The UFCA (and thus New York's Debtor-Creditor Law) defines "fair consideration" to include the *securing* of an antecedent debt in "good faith," which has been interpreted also to include the good-faith

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[62]*See* 11 U.S.C. § 547(c)(3) (protecting security interests to the extent they secure new value); (c)(5) (protecting transfers that create security interests in inventory); (c)(6) (protecting statutory liens); (c)(7) (protecting payments of domestic-support obligations); (c)(8) and (9) (protecting small-value transfers by individual debtors).

[63]11 U.S.C. § 546(e), (f), (g).

[64]Section 548(d)(2) defines "value" to include "satisfaction or securing of a present or antecedent debt of the debtor." 11 U.S.C. § 548(d)(2). Section 3(a) of the UFTA likewise provides that "[v]alue is given for a transfer or an obligation if, in exchange for the transfer or obligation, property is transferred or an antecedent debt is secured or satisfied." UFTA § 3(a).

satisfaction of an existing debt.[65] Consistent with these statutes, numerous decisions hold that the repayment of a valid debt is an exchange for which the debtor receives adequate "value." In some cases—in particular, cases dealing with a grant of lien to secure a pre-existing debt—that "value" has been described as the benefit received from the original extension of credit;[66] in other cases, it has been described as the benefit received by the debtor's dollar-for-dollar discharge of indebtedness.[67]

The distinction between a preferential transfer and a constructive fraudulent transfer, in the context of the UFCA, was addressed by the U.S. Court of Appeals for the Second Circuit in *Sharp International Corp. v. State Street Bank & Trust Co.*[68] In that case, after making a loan to the debtor, Sharp, State Street became suspicious that the debtor was engaged in fraud. State Street demanded repayment, and Sharp complied using funds that it fraudulently procured from other creditors. The trustee in Sharp's subsequent bankruptcy proceeding sought to avoid the repayment to State Street under New York law. In advancing his claim of constructive fraudulent conveyance, the trustee acknowledged "that the payment at issue discharged an antecedent debt and was made for a 'fair equivalent,'" but contended that "fair consideration [was] lacking because State Street did not receive the payment in 'good faith.'"[69]

The Second Circuit rejected the trustee's position and affirmed the dismissal of the constructive fraudulent conveyance claim. The court recognized that "[g]ood faith is an elusive concept" in the constructive fraud provision of the DCL—"a statute in which 'the issue of intent is irrelevant'"[70]—but con-

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[65]Section 272 of the DCL provides that "[f]air consideration" is given for property or an obligation "[w]hen such property, or obligation is received in good faith to *secure* a present advance or antecedent debt in amount not disproportionately small as compared with the value of the property, or obligation obtained." N.Y. DEBT. & CRED. LAW § 272 (McKinney 2001) (emphasis added). New York courts have also held, however, that "[g]ood faith *satisfaction* of an antecedent debt constitutes fair consideration." Northpark Assocs., L.P. v. S.H.C. Mergers, Inc., 8 A.D.3d 642, 644 (N.Y. App. Div. 2004) (emphasis added).

[66]*See, e.g.*, Geron v. Palladin Overseas Fund, Ltd. (*In re* AppliedTheory Corp.), 330 B.R. 362, 364 (S.D.N.Y. 2005) (loan proceeds previously received from lender were *per se* "reasonably equivalent" to security interest subsequently granted by debtor); Anand v. Nat'l Republic Bank of Chi., 239 B.R. 511, 517-18 (N.D. Ill. 1999) ("The key factor to bear in mind . . . is that the debtor receives value simply by securing a debt. The collateral makes [t]he loan possible; the value received by the debtor is access to the loan proceeds; in the same sense, the value received by a debtor who satisfies an antecedent debt is the proceeds of the loan. This value conferred on the debtor is no less significant when the debtor provides security for an antecedent debt, rather than doing so at the time of the original loan transaction.").

[67]*See, e.g.*, Jobin v. Ripley (*In re* M & L Bus. Mach. Co.), 198 B.R. 800, 810 n. 4 (D. Colo. 1996) (repayment of principal invested in Ponzi scheme provides value to the debtor "in the form of a dollar-for-dollar reduction in the investor's restitution claim" (collecting cases)).

[68]Sharp Int'l Corp. v. State St. Bank & Trust Co. (*In re* Sharp Int'l Corp.), 403 F.3d 43 (2d Cir. 2005).

[69]*Id.* at 54.

[70]*Id.* (quoting United States v. McCombs, 30 F.3d 310, 326 n.1 (2d Cir. 1994)).

cluded that "the decisive principle in this case is that a mere preference between creditors does not constitute bad faith," at least in situations where the transferee is not an insider of the debtor.[71] The Court of Appeals explained that "[a] conveyance which satisfies an antecedent debt made while the debtor is insolvent is neither fraudulent nor otherwise improper, even if its effect is to prefer one creditor over another."[72] The Second Circuit also affirmed the dismissal of the trustee's claim for intentional fraudulent conveyance, although it did not so clearly ground its decision on a distinction between preferential and fraudulent transfers.[73]

For purposes of the constructive fraudulent transfer provision of the UFCA, the Second Circuit thus narrowly construed the "good faith" component of "fair consideration." The court held that, while the "good faith" requirement in the UFCA's constructive fraud provision serves to police *insider* preferences—much like the one-year reach-back period for preferences in the Bankruptcy Code—it does not otherwise invite inquiry into a creditor's state of mind, unless the creditor actually *participated* in the debtor's misconduct.[74] Since the Bankruptcy Code and the UFTA do not have a similar "good faith" element in their constructive fraud provisions, the analysis under those statutes is more straightforward: the repayment or discharge of an antecedent debt provides the debtor with "reasonably equivalent value," and thus is not constructively fraudulent.[75]

The premise underlying *Sharp International* and similar decisions—that the debtor receives as much value as it gives when it repays a valid debt, so that debt repayments should be shielded from claims of constructive fraudulent transfer—is widely shared and yet not entirely self-evident. A debtor

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[71] *Id.* at 54; *see also* HBE Leasing Corp v. Frank, 48 F.3d 623, 634 (2d Cir. 1995) (explaining that the definition of "fair consideration" in New York statute "makes clear [that] even the preferential repayment of pre-existing debts to some creditors does not constitute a fraudulent conveyance, whether or not it prejudices other creditors," at least "where no actual intent to hinder, delay, or defraud creditors has been shown").

[72] *Sharp Int'l*, 403 F.3d at 54-55 (quoting Ultramar Energy Ltd. v. Chase Manhattan Bank, N.A., 191 A.D.2d 86, 90-91 (N.Y. App. Div. 1993)). As the *Ultramar* court went on to say: "It is not unfair, and therefore it is not a fraudulent conveyance, for the debtor arbitrarily to select the creditors whom he chooses to pay, although these favourites know that there will not be enough left to pay the others." *Ultramar*, 191 A.D.2d at 91 (quoting 1 GLENN, *supra* note 5, § 289a, at 494).

[73] *See id.* at 56.

[74] *Cf.* Richard B. Levin, *An Introduction to the Trustee's Avoiding Powers*, 53 AM. BANKR. L.J. 173, 181 (1979) (explaining that "[t]he good-faith requirement of Section 67d" of the Bankruptcy Act, which was modeled on the UFCA's constructive fraudulent conveyance provision, was "used to invalidate transfers to insiders in situations where the preference power is inadequate to reach questionable transactions" and that "[t]he Bankruptcy Code eliminates the good-faith requirement" and instead "invalidates certain insider preferences and expands the reach-back period to one year in these cases").

[75] *See* Pfeifer v. Hudson Valley Bank, N.A. (*In re* Pfeifer), No. 12-13852, 2013 WL 3828509, at *3-4 (Bankr. S.D.N.Y. July 23, 2013) (collecting authorities); *In re* Capmark Fin. Grp. Inc., 438 B.R. 471, 516 n.16 (Bankr. D. Del. 2010) (collecting authorities).

unquestionably receives a benefit through repayment of a debt: it satisfies an obligation equal to the amount of the repayment.[76] At the same time, when projected future recoveries on the satisfied claim are taken into account, the quotient of value received by the debtor is open to question. If the debtor is solvent or the debt at issue is fully secured, then the debtor receives a dollar of benefit for every dollar repaid.[77] On the other hand, if a debtor has assets sufficient to pay only a fraction of its unsecured obligations and repays an unsecured debt in full, the claim satisfied by the debtor has a value in bankruptcy (and in the marketplace) that is lower than its face value. In that circumstance, one could argue that the economic benefit received by the debtor by repaying its debt is less than, rather than equal to, the face value of the debt.

Although this argument has some force, there are still sound reasons to treat the repayment of an unsecured debt as providing value equal to its face amount, even when the debtor is insolvent. If debt repayments could be attacked as constructively fraudulent on the basis that an insolvent's debts are worth less than their face amount, essentially *all* pre-bankruptcy debt repayments could be set aside as constructive fraudulent transfers. In that case, Congress's comprehensive scheme for preference avoidance under section 547 of the Bankruptcy Code—including the numerous defenses to preference claims, as well as the strict time limitations placed on such claims—could be bypassed.

This result would not only subvert the statutory scheme governing preferences, but it would also likely have consequences in the marketplace. Exposing debt repayments to recapture for four or six years based on the debtor's insolvency at the time of the repayment—something that creditors cannot predict when they extend credit—would subject lenders to substantial uncertainty about the efficacy of their transactions with a debtor. In that scenario, lenders would be more reluctant to extend credit, especially to more risky borrowers, on a long-term basis. Creditors would also be incentivized to seek repayment from distressed borrowers as early as possible, when the

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[76] *See, e.g.*, NANCY C. DREHER ET AL., BANKRUPTCY LAW MANUAL § 9:35 (5th ed. 2013) ("[M]aking a preference in good faith is not a fraudulent conveyance because value is exchanged by the cancellation of the antecedent debt.").

[77] Thus, various cases hold that "[r]epayments of fully secured obligations" are not avoidable as fraudulent transfers because they "do not . . . put assets otherwise available in a bankruptcy distribution out of [the] reach" of other creditors. Henry v. Lehman Commercial Paper, Inc. (*In re* First Alliance Mortg. Co.), 471 F.3d 977, 1008 (9th Cir. 2006); *accord* Melamed v. Lake Cnty. Nat'l Bank, 727 F.2d 1399, 1402 (6th Cir. 1984); *In re* Nat'l Century Fin. Enters., Inc., 783 F. Supp. 2d 1003, 1030 (S.D. Ohio 2011). Some decisions have also rejected fraudulent transfer claims aimed at repayments of secured debt on the ground that sections 548(a) and 544(b) of the Bankruptcy Code only authorize avoidance of transfers of "an interest of the debtor in property." *See, e.g.*, Richardson v. Huntington Nat'l Bank (*In re* CyberCo Holdings, Inc.), 382 B.R. 118, 137, 142 (Bankr. W.D. Mich. 2008).

borrowers are still arguably solvent, even when bankruptcy is not imminent. By contrast, a rule under which the repayment or securing of a debt provides value equivalent to the debt offers comfort that, at least in the absence of intentional misconduct, debt repayments will not be subject to attack outside of the statutory preference period. Preserving commercial expectations in this way "promote[s] bankruptcy policy by allowing a troubled debtor the flexibility to secure or pay its debts in order to avoid default or reach an out-of-court settlement, thereby facilitating its rehabilitation."[78]

Finally, it should be noted that treating a debt repayment by an insolvent as a dollar-for-dollar exchange does not necessarily deprive a trustee of all means of challenging debt repayments on fraudulent transfer grounds. As noted above, modern fraudulent transfer statutes, including section 548(a) of the Bankruptcy Code, permit a plaintiff to avoid not only transfers of property, but also the debtor's incurrence of obligations.[79] If the *obligation* that is repaid is itself avoidable or otherwise invalid, the repayment will arguably not be for sufficient value, and so may be avoidable as well. Although it is difficult to find cases involving avoidance of transfers based on challenges to underlying obligations, several cases arising out of Ponzi schemes have suggested that the repayment to an investor may be vulnerable to attack as a constructive fraudulent transfer where the satisfied obligation was itself not legally enforceable based on malfeasance at the time of the loan.[80]

2. *Situations where a debt repayment may be a constructive fraudulent transfer*

The general rule that debt repayments may not be avoided as constructive fraudulent transfers has been subject to several exceptions. A notable one, as recognized in *Sharp International*, is for preferential payments made to insiders of an insolvent debtor. Under New York law, the insider exception is predicated on the judge-made rule that where the preferred creditor is an officer, director, or major shareholder of the transferor, the value given to the debtor may not be provided in "good faith," and may not constitute "fair

[78]Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 593 (1999).

[79]*See* 11 U.S.C. § 548(a)(1) (permitting trustee to avoid "any obligation . . . incurred by the debtor" that meets statutory requirements); *accord, e.g.*, UFTA § 4(a); N.Y. DEBT. & CRED. LAW § 273-276 (McKinney 2001).

[80]*See* Picard v. Merkin (*In re* Bernard L. Madoff Inv. Sec., LLC), 440 B.R. 243, 263-66 (Bankr. S.D.N.Y. 2010) (declining to dismiss constructive fraudulent transfer claims against Ponzi scheme investors alleged to have known about the fraud at the time of their investment, noting that "if the consideration for a transfer is satisfaction of an antecedent debt, the debt must be legally enforceable"); Bayou Superfund, LLC v. WAM Long/Short Fund II, L.P. (*In re* Bayou Grp., LLC), 362 B.R. 624, 638 (Bankr. S.D.N.Y. 2007) (distinguishing cases involving repayment of a "valid" antecedent debt based on the finding that the repayment on a Ponzi-scheme investment satisfied a debt that was fraudulently incurred).

consideration" as defined in the DCL.[81] As explained by one New York court, insiders "who should become aware of the insolvency [of the debtor] before that fact could become known to the general public" should not "devote the property of the corporation to the payment of their own debts and thereby leave nothing for the other creditors who did not know of its condition."[82]

The insider-preference rule exists in UFTA jurisdictions as well, even though that statute does not include the concept of "fair consideration" and its embedded element of "good faith." Section 5(b) of the UFTA expressly provides that a transfer made by an insolvent debtor to an insider with "reasonable cause to believe that the debtor was insolvent" is fraudulent as to creditors.[83] The UFTA, therefore, focuses not only on the debtor's financial condition but also on the facts available to and point of view of the insider-defendant.[84]

Debt repayments have also been avoided as constructive fraudulent transfers in situations where the debtor repays or secures the obligations of someone other than the debtor itself. For example, in *TOUSA*, the parent company of an enterprise, TOUSA, obtained new financing to settle claims asserted by existing creditors and secured the new debt with the assets of its subsidiaries. When creditors in TOUSA's bankruptcy sought to avoid the subsidiaries' grant of liens as constructive fraudulent transfers, the bankruptcy court concluded that the conveying subsidiaries were insolvent and "received no value in the form of debt relief," since they "did not obtain the satisfaction *of their own debts*" in the challenged transaction; rather, "they satisfied an obligation of [the parent company]."[85] Unable in those circumstances to rely on the rule that securing an antecedent debt constitutes value as a matter of law, the court delved into the more fact-intensive question

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[81]*See* Sharp Int'l Corp. v. State St. Bank & Trust Co., 403 F.3d 43, 54 (2d Cir. 2005).

[82]S. Indus. v. Jeremias, 66 A.D.2d 178, 184 (N.Y. App. Div. 1978).

[83]UFTA § 5(b). The rule that insider preferences can be avoided as fraudulent transfers does not have independent existence under the Bankruptcy Code; instead, when preferential transfers are made to insiders, the Bankruptcy Code permits a trustee's avoidance powers under section 547 to reach back one year rather than the typical ninety days. *See* Levin, *supra* note 74, at 181 (commenting on the elimination of the insider-preference rule in the Bankruptcy Code's fraudulent transfer provision). In addition, section 544(b) of the Bankruptcy Code permits a trustee to attack insider preferences to the extent allowed under applicable state fraudulent transfer law. 11 U.S.C. § 544(b).

[84]The insider-preference rule, as codified in the UFTA, has drawn strong criticism. Commentators have argued that in addition to "blur[ring] the distinction between a fraudulent transfer and a preference," section 5(b) permits an individual creditor to attack a repayment even to an insider that "may have obtained no unfair advantage over other creditors." Michael L. Cook & Richard E. Mendales, *The Uniform Fraudulent Transfer Act: An Introductory Critique*, 62 AM. BANKR. L.J. 87, 88-90 (1988). Compensating in part for the breadth of section 5(b), the UFTA restricts insider-preference claims to those that are brought within one year of the challenged payment. UFTA § 9.

[85]Official Comm. of Unsecured Creditors of TOUSA, Inc. v. Citicorp N. Am. (*In re* TOUSA, Inc.), 422 B.R. 783, 844 (Bankr. S.D. Fl. 2009) (emphasis added).

whether the conveying subsidiaries received value in the form of indirect benefits, such as the opportunity to stave off a parent-level bankruptcy and the negative consequences that would have followed for the subsidiaries.[86] In the end, the court concluded that reasonably equivalent value was not exchanged, and it unwound the transaction,[87] a result that was ultimately upheld on appeal.[88]

Cases involving leveraged buyouts (or "LBOs") similarly demonstrate that transactions involving the securing of debt can in some circumstances be attacked as constructively fraudulent. In a typical LBO, the debtor grants a lien on its assets to secure new loans, the proceeds of which are used to buy out existing equity holders. Where the debtor is alleged to have been rendered insolvent by an LBO, unsecured creditors and bankruptcy trustees have pursued constructive fraudulent transfer claims seeking to avoid such liens.[89] There are two factors, however, that distinguish an LBO transaction from situations where transfers to secure obligations have been held to be outside the reach of constructive fraudulent transfer law. First, the liens at issue in LBOs secure advances of new financing rather than antecedent debts, and thus do not qualify as preferences. Second, the liens granted in LBOs are not considered to be for "value" in the way that transfers to secure antecedent debts are. The theory underlying challenges to liens in the LBO context is that, although the loan proceeds are initially provided to the debtor in exchange for the liens, they are immediately transferred to equity holders, such that the debtor acts essentially as a conduit, and not a recipient of value.[90]

Another situation in which debt repayments may be avoidable as constructive fraudulent transfers is the narrow circumstance in which a loan is "recharacterized" as equity. For example, in *Fitness Holdings International*,

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[86]*See id.* at 846.

[87]*See id.* at 845-50.

[88]*See* Citicorp N. Am., Inc. v. Official Comm. of Unsecured Creditors (*In re* TOUSA, Inc.), 680 F.3d 1298, 1303-09, 1311-13 (11th Cir. 2012).

[89]*See, e.g.*, United States v. Tabor Court Realty Corp., 803 F.2d 1288, 1297 (3d Cir. 1986) (affirming avoidance of liens granted in an LBO under UFCA's constructive fraudulent transfer provisions).

[90]*See, e.g.*, Murphy v. Meritor Sav. Bank (*In re* O'Day Corp.), 126 B.R. 370, 394 (Bankr. D. Mass. 1991) ("[W]hen a target company assumes liabilities or transfers security interests in its property and the consideration (or loan proceeds) is immediately passed to target's shareholders or third parties then the absence of fair consideration may be equally evident [as when there is a gratuitous transfer]."). Fraudulent transfer claims have also been brought in some cases against pre-LBO shareholders, *see* Weisfelner v. Fund 1 (*In re* Lyondell Chem. Co.), 503 B.R. 348, 354 n.6 (Bankr. S.D.N.Y. 2014) (citing cases)), although such claims have often been barred by the Bankruptcy Code's safe harbors on the basis that they involve securities settlement payments made through financial institutions. *See, e.g.*, Brandt v. B.A. Capital Co. LP (*In re* Plassein Int'l Corp.), 590 F.3d 252, 256 (3d Cir. 2009) (section 546(e) of the Bankruptcy Code precluded constructive fraudulent transfer claims challenging payments made to equity holders in LBO); Contemporary Indus. Corp. v. Frost, 564 F.3d 981, 985-87 (8th Cir. 2009) (same).

the Ninth Circuit addressed a payment by a debtor in repayment of a purported loan.[91] The debtor, a home fitness corporation, had received almost $25 million in loans from its largest shareholder in the form of subordinated promissory notes, and repaid approximately $12 million prior to bankruptcy. In the bankruptcy, the trustee sought to avoid this payment as constructively fraudulent. The Ninth Circuit, in reinstating the claim, noted that "to the extent a transfer constitutes repayment of the debtor's antecedent or present debt, the transfer is not constructively fraudulent."[92] The court went on, however, to direct the district court to assess whether the debtor's obligation to its shareholder constituted a "right to payment"—i.e., a debt rather than equity under applicable state law.[93]

Beyond these specific situations, some New York courts, relying on the "good faith" element of "fair consideration" in the DCL, have concluded that debt repayments may be constructively fraudulent outside the insider-preference context. For example, in a case arising out of Bernard Madoff's Ponzi scheme, *Picard v. Merkin*, the bankruptcy court held that the repayment of principal invested in the scheme could be challenged as a constructive fraudulent conveyance under New York law—even though such a repayment satisfied the debtor's obligation to make restitution to the investor for fraud—where the investor allegedly had knowledge (or a state of mind akin to knowledge) of the debtor's fraud at the time of the initial investment. The court distinguished *Sharp International*, in which the creditor simply received *payment* with alleged knowledge of the debtor's fraud, from cases in which the creditor lacked good faith when the antecedent debt was *incurred* in the first place.[94] Notably, the *Merkin* decision involved allegations of "conscious misbehavior" by the defendant in connection with the Madoff fraud,[95] and as a result is arguably consistent with *Sharp International*'s ruling that actual *participation* in fraud by a creditor is sufficient to sustain a claim of bad faith against the creditor under the DCL.[96]

Several courts outside New York have likewise rejected a *per se* rule in favor of an inquiry into the facts and circumstances surrounding the debt

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[91]Official Comm. of Unsecured Creditors v. Hancock Park Capital II, L.P. (*In re* Fitness Holdings Int'l, Inc.), 714 F.3d 1141 (9th Cir. 2013).

[92]*Id.* at 1145-46.

[93]*Id.* at 1149-50.

[94]Picard v. Merkin (*In re* Bernard L. Madoff Inv. Sec., LLC), 440 B.R. 243, 264-66 (Bankr. S.D.N.Y. 2010).

[95]*Id.* at 258-59.

[96]By comparison, in a case arising out of Marc Dreier's fraudulent investment scheme—where the trustee did not allege that the defendant knowingly participated in the debtor's fraud—a bankruptcy court held broadly that the repayment of principal invested in a Ponzi scheme did *not* constitute a constructive fraudulent conveyance under the DCL. *See* Gowan v. Patriot Grp., LLC (*In re* Dreier LLP), 452 B.R. 391, 437 (Bankr. S.D.N.Y 2011) (dismissing constructive fraud claims challenging the repayment of principal invested in a Ponzi scheme).

repayment to determine if reasonably equivalent value was exchanged. For example, the bankruptcy court in Delaware, in denying a motion to dismiss a constructive fraudulent transfer claim challenging a debt repayment, required development of a factual record to consider "other factors, including the good faith of the parties, the difference between the amount paid and the fair market value, and whether the transaction was at arms length."[97] But while cases in this vein allude to the possibility that a debt repayment could be made for less than reasonably equivalent value, it is difficult to find decisions that actually avoid debt repayments to non-insiders on this basis.[98] Moreover, recent decisions in Delaware have stated broadly that "[w]here a bona fide antecedent debt exists, a debtor's payment on account of that creditor's claim, even if it has the result of preferring that creditor over others, is not by itself a fraudulent transfer."[99]

In summary, despite the exceptions discussed above, there is relatively broad support in the case law for a rule under which the repayment or securing of a valid antecedent debt, where no insider is involved, is deemed to be made in exchange for equivalent value and is not constructively fraudulent. As discussed in the next section, the analysis and results have been more disparate in the context of actual-intent fraudulent transfers.

B. Intentional fraudulent transfer

Before delving into the case law dealing with intentional fraudulent transfer claims directed at debt repayments, it is helpful to consider more broadly what it means for a debtor to "hinder, delay, or defraud" its creditors.

As discussed above, modern statutes identify "badges of fraud" that may be considered by courts in assessing whether an actual-intent fraudulent transfer has occurred.[100] Those badges of fraud provide some insight into the "unjust diminution" that fraudulent transfer law is intended to prevent. Many of the traditional badges of fraud focus on whether the debtor's aim was to escape liabilities. *Twyne's Case* thus emphasized that a writ was pending against Pierce at the time he transferred his flock. The UFTA simi-

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[97]Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (*In re* Exide Techs., Inc.), 299 B.R. 732, 748 (Bankr. D. Del. 2003) (quoting Peltz v. Hatten, 279 B.R. 710, 736-37 (D. Del. 2002)).

[98]*See, e.g.*, Anand v. Nat'l Republic Bank of Chi., 239 B.R. 511, 518 (N.D. Ill. 1999) (agreeing that it is a "safe assumption" that the debtor received reasonably equivalent value in exchange for securing a debt, but concluding that "a *per se* rule would represent a departure from the Seventh Circuit's emphasis on 'all the facts of each case' as part of the reasonably equivalent value analysis" (quoting Bundles v. Baker, 856 F.2d 815, 824 (7th Cir. 1988))).

[99]*In re* Capmark Fin. Grp. Inc., 438 B.R. 471, 518 (citing Official Comm. of Unsecured Creditors of Champion Enters., Inc. v. Credit Suisse (*In re* Champion Enters., Inc.), No. 09-14014, 2010 WL 3522132 (Bankr. D. Del. Sept. 1, 2010)). *See also* Brian M. Resnick & Darren S. Klein, *Delaware Court "Champions" Per Se Rule for Constructive Fraudulent Transfers*, 29 Am. Bankr. Institute J. 44 (2011) (discussing "per se rule" that satisfaction of an antecedent debt cannot be a constructive fraudulent conveyance).

[100]*See supra* Part I.A.

larly gives weight to whether a transfer occurred after "the debtor had been sued or threatened with suit,"[101] shortly before or after the debtor's incurrence of "a substantial debt,"[102] or at a time when the debtor was insolvent or would be rendered insolvent by the transfer.[103] The focus on the temporal proximity of a challenged transfer to looming debts or insolvency is consistent with the goal that fraudulent transfer law should prevent debtors from deliberately trying to render their assets judgment proof.

Beyond harming creditors by removing assets from their reach, several badges of fraud also focus on whether the debtor unfairly retained control of those assets. Thus, one factor to which the Star Chamber paid particular attention in *Twyne's Case* was that the "donor continued in possession [of the sheep], and used them as his own."[104] No fewer than five badges of fraud enumerated in the UFTA refer to situations where a debtor in some way retains access to property that should be available to creditors. These include not only the situation where "the debtor retained possession or control of the property transferred after the transfer,"[105] but also those where "the transfer . . . was to an insider"[106] (such as a relative, in the case of an individual, or an affiliate or control person in the case of a corporation[107]), where the debtor "absconded" with, removed, or concealed assets,[108] and where "the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor."[109]

An inference of actual intent to "hinder, delay, and defraud" creditors is therefore most likely in cases where, in addition to diminution of the estate, the debtor or its principals personally profited at creditors' expense.[110] In this sense, while preference law protects priority of distribution among creditors, fraudulent transfer law can be viewed as protecting the priority of debt over equity—that is, as enforcing the basic axiom that the creditors of an insolvent debtor have a superior right to the debtor's assets compared to the debtor and its shareholders. Indeed, the "absolute priority rule" in chapter 11 cases, which provides that, absent consent, there can be no recovery for equity holders under a plan of reorganization until all classes of creditors are

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[101]UFTA § 4(b)(4) (1984).

[102]*Id.* § 4(b)(10).

[103]*Id.* § 4(b)(9).

[104]Twyne's Case, (1601) 76 Eng. Rep. 809 (K.B.).

[105]UFTA § 4(b)(2) (1984).

[106]*Id.* § 4(b)(1).

[107]*Id.* § 1(7).

[108]*Id.* § 4(b)(6), (7).

[109]*Id.* § 4(b)(11).

[110]*See* 5 COLLIER ON BANKRUPTCY ¶ 548.04[1][a] (Alan Resnick & Henry Sommer eds., 16th ed. 2013) ("Most cases under section 548(a)(1)(A) deal with the intent to defraud. It is generally the intent to mask personal control to creditors' detriment through the use of sham or bogus legal title . . . while retaining the benefits of ownership.").

paid in full,[111] has its roots in fraudulent conveyance law. The rule was born of fraudulent conveyance cases in the early twentieth century challenging railroad reorganizations that resulted in new companies "with the same shareholders, the same bondholders, and the same property" as the prepetition debtor, but with unsecured and other junior debt eliminated in the reorganization process.[112] Faced with this outcome, the argument of unsecured creditors in these cases—which the Supreme Court found compelling, and which Congress addressed in enacting the absolute priority rule—was this: "why should shareholders take anything when we receive nothing?"[113]

This is not to say that a fraudulent transfer can only occur where the debtor retains control over assets to which creditors have a superior claim. A gift by an insolvent debtor or a diversion of assets for less than reasonably equivalent value can be avoidable, too, even when resulting in a complete alienation of title. But these latter situations do not describe debt repayments, which as discussed above, are necessarily "for value." As explained in the remainder of this section, in the context of debt repayments, the intent to "hinder, delay, and defraud creditors" can be given meaning primarily by reference to those situations in which the debtor's principals and owners intentionally benefit at the expense of creditors, thus disrupting the well-established priority of creditors over shareholders.

1. *Early case law from the Supreme Court*

Three Supreme Court decisions of approximately 100 years ago touched on the question of whether preferential transfers could be avoided as fraudulent under the Bankruptcy Act of 1898, which at the time recognized as avoidable only preferences and *intentional* fraudulent transfers.[114] In *Coder v. Arts*,[115] decided in 1909, a bankruptcy trustee sought to avoid the debtor's grant of a mortgage to secure an antecedent debt. The Eighth Circuit held that the mortgage "did not, as a matter of law, constitute any evidence of any intent on the part of the bankrupt to hinder, delay, or defraud other creditors within the meaning of § 67e, notwithstanding the fact that its necessary effect was to hinder and delay other creditors, and to deprive them of an opportunity they might otherwise have had to collect larger portions of their

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[111] *See* 11 U.S.C. §§ 1129(b)(2)(B), (C).

[112] Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 77-80 (1991) (attributing development of absolute priority rule to outcome of fraudulent conveyance cases, including Northern Pacific Railway Co. v. Boyd, 228 U.S. 482 (1913)).

[113] *Id.*

[114] *See* 4 COLLIER ON BANKRUPTCY ¶ 67.29 & nn.1-2 (James William Moore ed., 14th ed. 1978) (reproducing the text of and discussing section 67 of Bankruptcy Act). A constructive fraudulent transfer provision was not added to federal bankruptcy law until the Chandler Act of 1938 incorporated most essential terms of the UFCA. *Id.* ¶¶ 67.29[2], 67.34[3].

[115] Coder v. Arts, 213 U.S. 223 (1909).

claims."[116] The Supreme Court thought this went too far. It agreed that "[a]n attempt to prefer is not to be confounded with an attempt to defraud, nor a preferential transfer with a fraudulent one."[117] And it further stated that "a conveyance made in good faith, whether for an antecedent or present consideration, is not forbidden [as a fraudulent transfer] notwithstanding the effect may be that it hinders or delays creditors by removing from their reach assets of the debtor."[118] Nonetheless, the Court concluded, "[w]e do not agree . . . that the giving of the mortgage and its effect upon other creditors could not be considered as an item of evidence in determining the question of fraud. What we hold is that, to constitute a conveyance voidable under § 67e, actual fraud must be shown."[119] The Court thus affirmed, but on the basis of the lower court's finding that the debtor, although he intended to prefer his mortgagee, "had no intention to hinder, delay, or defraud his creditors."[120]

In 1913, the Supreme Court followed a similar approach in *Van Iderstine v. National Discount Co.*,[121] a case in which a lender made a secured loan to the debtor with knowledge that the proceeds were to be used to pay off an imminently maturing debt.[122] In addressing a fraudulent conveyance claim directed at the pledge of collateral to the lender, the Court observed that "[c]onveyances may be fraudulent because the debtor intends to put the property and its proceeds beyond the reach of his creditors; or because he intends to hinder and delay them as a class; *or by preferring one who is favored above the others*."[123] The Court also emphasized, however, that the Bankruptcy Act "recognizes the difference between the intent to defraud and the intent to prefer, and also the difference between a fraudulent and a preferential conveyance."[124] The Court thus rejected the notion that a transfer is a fraudulent conveyance as a matter of law where the transferee "knew that the money was to be used in paying an existing debt."[125] Instead, the Court held, the lender could not be held liable on fraudulent transfer grounds where it "had no knowledge of any intent to defraud," regardless of "whether the

[116]*Id.* at 231-32.

[117]*Id.* at 241 (internal quotation marks omitted). The Supreme Court drew this language from *Githens v. Shiffler*, 112 F. 505, 508 (M.D. Pa. 1902), which similarly stated: "An intent to prefer is not to be confounded with an intent to defraud nor a preferential transfer with a fraudulent one."

[118]*Coder*, 213 U.S. at 243 (quoting Lansing Boiler & Engine Works v. Ryerson, 128 F. 701, 703 (6th Cir. 1904)).

[119]*Id.* at 244.

[120]*Id.*

[121]Van Iderstine v. Nat'l Disc. Co., 227 U.S. 575 (1913).

[122]*Id.* at 580.

[123]*Id.* at 582 (emphasis added).

[124]*Id.*

[125]*Id.* at 581-82.

money was used to pay an existing debt."[126]

It was against this backdrop that the Supreme Court decided *Dean v. Davis* in 1917.[127] In that case, the debtor, Jones, obtained bank notes through forgeries, and the bank, after discovering the fraud, demanded that the notes be paid. Jones, fearing arrest and prosecution, mortgaged his property to his brother-in-law, Dean, in exchange for which Dean agreed to repay the bank notes. When Jones later filed for bankruptcy, the trustee sued to avoid the mortgage Dean held. The Supreme Court observed that the mortgage was not a preference, since it did not secure an existing debt; rather, it secured a contemporaneous advance by Dean.[128] But in considering whether the mortgage was a fraudulent transfer, the Court declared that a "transaction may be invalid both as a preference and as a fraudulent transfer," and that "[i]t may be invalid only as a preference or only as a fraudulent transfer."[129] The Court further noted that the grant of a lien to obtain funds needed to repay an existing debt is not always fraudulent, such as where the debtor intends to "extricate himself from a particular difficulty and be enabled to promote the interest of all other creditors by continuing his business."[130] But "where the advance is made to enable the debtor to make a preferential payment with bankruptcy in contemplation, the transaction presents an element upon which fraud may be predicated."[131] The debtor's intent, the Court continued, depends on the circumstances: "The fact that the money advance is actually used to pay a debt does not necessarily establish good faith. It is a question of fact in each case what the intent was with which the loan was sought and made."[132] In reviewing the findings of the lower court, the Supreme Court found no error in the conclusion that Jones, who "willingly sacrificed his property and his other creditors to avert a threatened criminal prosecution," granted the mortgage to Dean with fraudulent intent.[133]

Notably, none of *Coder*, *Van Iderstine*, or *Dean* actually held that the repayment of a valid debt was a fraudulent transfer: *Coder* and *Van Iderstine* affirmed the dismissal of fraudulent transfer claims. And while *Dean* affirmed the avoidance of a lien granted to a family member to finance a preferential loan repayment,[134] it did not permit avoidance of the loan repayment itself,

[126] *Id.* at 583.
[127] 242 U.S. 438 (1917)
[128] *Id.* at 443.
[129] *Id.* at 444.
[130] *Id.*
[131] *Id.*
[132] *Id.*
[133] *Id.* at 445.
[134] In 1938 and again in 1952, Congress added language to section 67d(3) of the former Bankruptcy Act in an attempt to codify *Dean*. *See* JAMES A. MACLACHLAN, HANDBOOK OF THE LAW OF BANK-

which was made to a non-insider. But in each of those cases, the Supreme Court in *dicta* cast doubt on the notion that preferential payments can never, as a matter of law, be in fraud of creditors. As the Second Circuit explained shortly after *Dean* was decided, "evidence proving an intent to prefer is (usually at all events) relevant to an alleged intent to defraud or delay."[135] Nonetheless, "a very plain desire to prefer, and thereby incidentally to hinder creditors, is (1) not as a matter of law an intent obnoxious to [the Act's fraudulent transfer provision]; and (2) is not persuasive in point of fact that such intent, evil in itself, ever existed."[136]

In short, under these early Supreme Court decisions, the debtor's intent to prefer one creditor over others was viewed as potentially probative of a separate intent to hinder, delay, or defraud creditors. But a debtor's intent to prefer was *not* sufficient to sustain a fraudulent transfer claim absent additional evidence of misconduct, such as the evidence in *Dean* of insider dealing aimed at concealing criminal fraud on creditors. Ultimately, though, the Supreme Court did not clearly define the boundary between the intent to prefer and the intent required for a fraudulent transfer, leaving that issue open for future cases.

2. Boston Trading *and the dichotomy between preferential and fraudulent transfers*

Decades after the Supreme Court's dictum in *Dean* that a preferential transfer can be fraudulent where intent to defraud—above and beyond intent to prefer—is demonstrated, various courts and commentators began to draw a strict distinction between preferential and actual-intent fraudulent trans-

RUPTCY § 243 (1956); Levin, *supra* note 74, at 183 & 184 n.48. But "each attempted codification [was] broader than the holding," and the breadth of the provision was criticized for discouraging arms-length refinancing transactions. Levin, *supra* note 74, at 182-183. Congress omitted the codification of *Dean* when it enacted the Bankruptcy Code, raising the question whether *Dean* is still good law. One commentator has observed that "[t]he Supreme Court was able to reach the result in *Dean v. Davis* in the absence of a statutory provision precisely describing the case. No doubt the courts will reach a similar result should similar facts arise again, even in the absence of Bankruptcy Act § 67d(3)." *Id.* at 183. Several courts have applied *Dean* following the enactment of the Bankruptcy Code in situations where a creditor provides secured financing to enable the debtor to repay that same creditor's unsecured claim. *See, e.g.*, Craig v. Minden Exch. Bank & Trust Co. (*In re* Craig), 92 B.R. 394, 401 (Bankr. D. Neb. 1988) (finding transfer to be fraudulent under *Dean* in "a two party transaction" where bank made secured loan to enable debtor to make a preferential payment back to the bank); Coleman Am. Moving Servs. v. First Nat'l Bank & Trust Co. of Kearney, Neb. (*In re* Am. Props., Inc.), 14 B.R. 637, 642-43 (Bankr. D. Kan. 1981) ("Certainly the inference of knowledge by the creditor must be very great where the creditor orchestrates a scheme to 'pay off' its unsecured claim and substitute a secured claim.").

[135]Richardson v. Germania Bank of City of N.Y., 263 F. 320, 324 (2d Cir. 1919)).

[136]*Id.* at 325; *see also id.* at 323 ("Wherefore the definition of the Dean Case leaves the old question still to be answered; and that question, in terms of this case, is: Do the facts prove any more than an intent to prefer, remembering it as law that an intent to prefer is not the same as an intent to defraud or delay? A debtor may have both intents, and proof of one may help out proof of the other; but by merely having one he cannot be conclusively presumed to have the other also.").

fers. For example, in a 1937 decision, a judge in the Southern District of New York declared that "[u]nder the Statute of Elizabeth a transfer by an insolvent debtor to pay or to secure an antecedent debt has *never* been treated as a transfer to hinder, delay or defraud creditors, although it is self-evident that other creditors are necessarily hindered and delayed by such a transfer."[137] Three years later, in his treatise on fraudulent conveyances and preferences, Professor Glenn echoed this statement, stating that "[i]f there is in our law one point which is more ungrudgingly accepted than others, it is that the preferential transfer does not constitute a fraudulent conveyance."[138]

Most notable among the modern cases supporting a dichotomy between preferential and fraudulent transfers—including intentional fraudulent transfers—is the First Circuit's 1987 decision in *Boston Trading Group, Inc. v. Burnazos*.[139] In that case, two individuals, Shaw and Kepreos, agreed to buy investment firm Boston Trading Group from Burnazos on credit. After the sale, they unlawfully churned customer accounts, and used the proceeds to pay the purchase price in installments to Burnazos, who was alleged to have known about the fraudulent activity when he received at least some of the installment payments. When Boston Trading Group collapsed, its receiver sued Burnazos to recover the payments under Massachusetts's fraudulent conveyance law, which at the time mirrored the UFCA. The district court concluded that insufficient evidence existed to allow an actual-intent claim to proceed to a jury, but the court permitted a jury to render a verdict on constructive-fraud claims, which it did in favor of the receiver. Both sides appealed.

The First Circuit's decision in *Boston Trading*, written by now-Justice Breyer, includes an exhaustive discussion of the history and purpose of fraudulent transfer law. The court explained that, unlike the preference statute in the Bankruptcy Code, "the intent of fraudulent conveyance statutes is not to provide equal distribution of the estates of debtors among their creditors."[140] Rather, fraudulent conveyance law is "a set of legal (not equitable) doctrines designed for very different purposes,"[141] and it does not extend to the repayment of valid debts: "The basic object of fraudulent conveyance law is to see that the debtor uses his limited assets to satisfy *some* of his creditors; it normally does not try to choose among them."[142]

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[137]Irving Trust Co. v. Kaminsky, 19 F. Supp. 816, 818 (S.D.N.Y. 1937) (emphasis added).

[138]1 GLENN, *supra* note 5, § 289, at 488 (rev. ed. 1940); *see also* JAMES A. MACLACHLAN, HANDBOOK OF THE LAW OF BANKRUPTCY § 243 (1956) ("Preferences have commonly been considered as one degree less obnoxious than fraudulent conveyances and, from this point of view, it seems anomalous to stigmatize as fraudulent actions merely accessory to a preference.").

[139]Boston Trading Grp., Inc. v. Burnazos, 835 F.2d 1504, 1512 (1st Cir. 1987).

[140]*Id.* at 1509 (quoting 1 GLENN, *supra* note 5, § 289 (internal quotation marks omitted)).

[141]*Id.* at 1508 (internal quotation marks omitted).

[142]*Id.* at 1509.

Applying these principles, the First Circuit held that the repayment of a debt to non-insider Burnazos was not a fraudulent conveyance, despite Burnazos's alleged knowledge that he was being repaid with the proceeds of a fraud. The court noted that it had "found no modern case (nor any reference in any modern case, treatise, or article to any case in the past 400 years) that has found a fraudulent conveyance in such circumstances," which the Court did not find surprising, since "[f]raudulent conveyance law is basically concerned with transfers that 'hinder, delay or defraud' creditors; it is not ordinarily concerned with how such debts were created."[143] This rationale, moreover, was deemed to apply both to intentional and constructive fraudulent transfer claims. As explained by the First Circuit, "to find an actual intent to defraud creditors when . . . an insolvent debtor prefers a less worthy creditor, would tend to deflect fraudulent conveyance law from one of its basic functions (to see that an insolvent debtor's limited funds are used to pay *some* worthy creditor), while providing it with a new function (determining *which* creditor is the more worthy)."[144]

Other appellate courts have adopted similar reasoning. In *B.E.L.T., Inc. v. Wachovia Corp.*,[145] the Seventh Circuit stated that "a preference among creditors," absent insider dealing, is not a fraudulent conveyance. In *B.E.L.T*, a bank extended credit to a corporation that was engaged in fraud, and it was repaid after it suspected that "mischief was afoot."[146] While noting that "[a] trustee in bankruptcy could have avoided some or all of the preferential transfer," Judge Easterbrook explained that the transfer was not avoidable as a fraudulent conveyance, because "in the end this is nothing but a preference."[147] As in *Boston Trading*, the court highlighted the dearth of cases treating a repayment of a creditor that "dealt with the debtor at arms' length[ ] as a fraudulent conveyance on the theory that paying an antecedent debt evinces actual intent to hinder, delay, or defraud any other creditor of the debtor."[148]

3. *More recent cases: rejection of a strict dichotomy*

Unlike in *Boston Trading*, several courts have recently found that debt repayments can in some circumstances be avoided as intentional fraudulent transfers. They have grounded their decisions in the text of the relevant statutes: unlike constructive fraud provisions, statutes barring intentional fraudulent transfers focus on the *intent* of the transferor, not the *effect* of the transfer. Although providing a defense to transferees that give "value" in

[143]*Id.* at 1510.
[144]*Id.* at 1511.
[145]B.E.L.T., Inc. v. Wachovia Corp., 403 F.3d 474, 477 (7th Cir. 2005).
[146]*Id.* at 476.
[147]*Id.* at 477-78.
[148]*Id.* at 478 (internal quotation marks and alterations omitted).

"good faith," the statutory language of the actual-intent provisions does not require the plaintiff to demonstrate a deficiency in the value received by the debtor or an injury to creditors.[149]

This is a distinctive feature of actual-intent provisions modeled on the Statute of Elizabeth. Failed attempts and unsuccessful conspiracies may be cognizable under criminal law; but civil liability is rarely, if ever, premised on an intended harm that does not materialize.[150] The simple logic that civil liability should be imposed only when there is measurable harm, along with the notion that fraudulent transfer law exists to prevent actual harm to creditors, has led some courts to conclude that *all* fraudulent transfer claims include a damages requirement. As one court explained: "a conveyance cannot be fraudulent as to creditors if the debtor's solvency is not affected thereby, that is, if the conveyance does not deplete or otherwise diminish the value of the assets of the debtor's estate remaining available to creditors."[151]

Nonetheless, as noted above, other courts have concluded that the elements of an intentional fraudulent transfer claim may be established even when a debtor receives value by discharging an antecedent debt. In particular, courts have regularly concluded that transfers made in furtherance of Ponzi schemes were intended to hinder, delay, and defraud creditors—"those left holding the bag when the scheme was uncovered."[152] They have done so while also recognizing that repayment by a Ponzi scheme operator of a *principal* investment constitutes a dollar-for-dollar satisfaction of an existing restitution claim held by the investor, and thus provides "value" to the debtor.[153]

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[149]*See, e.g.*, Amusement Indus., Inc. v. Midland Ave. Assocs., LLC, 820 F. Supp. 2d 510, 530 (S.D.N.Y. 2011) (claim for intentional fraud can be maintained if the requisite state of mind of the debtor is proved, "even where fair consideration was paid and where the debtor remains solvent"); Dev. Specialists, Inc. v. Hamilton Bank, N.A. (*In re* Model Imperial, Inc.), 250 B.R. 776, 793-94 (Bankr. S.D. Fla. 2000) ("If diminution of the estate were an essential element of an [actual-intent claim under section 548(a)(1)(A)], then [the constructive fraud provision, section 548(a)(1)(B)] would be redundant.").

[150]*See, e.g.*, Lewis Invisible Stitch Mach. Co. v. Columbia Blindstitch Mach. Mfg. Corp., 80 F.2d 862, 864 (2d Cir. 1936) (Hand, J.) ("Whatever may be the rule in criminal conspiracies, it is well settled that the civil liability does not depend upon the confederation (which need be alleged only by way of inducement), but upon the acts committed in realization of the common purpose.").

[151]Lippe v. Bairnco Corp., 249 F. Supp. 2d 357, 375 (S.D.N.Y. 2003) (quoting 30 N.Y. Jur. 2d *Creditors' Rights & Remedies* § 305 (2003)) (internal quotation marks and alterations omitted); *see also* Scholes v. Lehmann, 56 F.3d 750, 756-57 (7th Cir. 1995) ("To insist that the transferor be made no worse off by the exchange in order to avoid a finding of fraudulent conveyance could be criticized as doing violence to the structure of the statute. . . . [But] [i]f valuable consideration means full consideration, then even if there is intent to defraud there can be no harm to creditors, since the debtor's estate has not been depleted by a cent.").

[152]Picard v. Katz, 462 B.R. 447, 453 (S.D.N.Y. 2011); *accord* Bear, Stearns Secs. Corp. v. Gredd (*In re* Manhattan Inv. Fund Ltd.), 397 B.R. 1, 12 n.16 (S.D.N.Y. 2007).

[153]*See* Jobin v. Ripley (*In re* M & L Bus. Mach. Co.), 198 B.R. 800, 810 n.4 (D. Colo. 1996) (recognizing that a repayment of principal invested in a Ponzi scheme provides value to the debtor "in the form of a dollar-for-dollar reduction in the investor's restitution claim against the Ponzi scheme" (collecting cases)).

For example, in *Picard v. Katz*,[154] a case brought by the trustee of Bernard Madoff's brokerage firm against the owners of the New York Mets, the district court recognized that "the principal invested by any of Madoff's customers 'gave value to the debtor.'"[155] Yet the court held that the defendants could avoid liability for repayments of that principal only "by proving their good faith" under section 548(c) of the Bankruptcy Code.[156] The court thus rejected the idea that the return of principal, as the repayment of a debt, could not be avoided as a fraudulent transfer. Notably, the defendants in *Picard* resisted disgorging not only the repayments of their principal investments, but also payments they received in excess of that amount. They contended that these "profits" were reflected on broker account statements that, although fictitious, represented binding obligations of the debtor. Relying on the Second Circuit's reasoning in *Sharp International*—that "[a] conveyance which satisfies an antecedent debt made while the debtor is insolvent is neither fraudulent nor otherwise improper"[157]—the defendants argued that even profit payments were immune to avoidance. The court disagreed. It concluded that *Sharp International* "did not apply this holding to actually fraudulent transfers," and instead governed only claims of constructive fraud.[158] The court concluded that the trustee had stated valid avoidance claims, the success of which would depend on the defendants' ability to establish a "value" and "good faith defense" under section 548(c).[159]

Similarly, in *Gowan v. Patriot Group, LLC (In re Dreier LLP)*,[160] a case arising out of the Ponzi scheme conducted by attorney Marc Dreier, the trustee acknowledged that repayments of principal invested in the scheme were made in exchange for value because they "extinguished a common law claim, such as restitution, that defendants may have had against the estate."[161] On that basis, the court dismissed claims to avoid the repayments as constructively fraudulent.[162] As in *Picard v. Katz*, however, the court concluded that liability for claims of intentional fraudulent transfer could be defeated only if the defendants demonstrated their "good faith."[163]

The breakdown of the strict dichotomy articulated in *Boston Trading* can

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[154]Picard v. Katz, 462 B.R. 447 (S.D.N.Y. 2011).

[155]*Id.* at 453.

[156]*Id.* at 454.

[157]Sharp Int'l Corp. v. State St. Bank & Trust Co., 403 F.3d 43, 54-55 (2d Cir. 2005) (quoting Ultramar Energy Ltd. v. Chase Manhattan Bank, N.A., 191 A.D.2d 86, 90-91 (N.Y. App. Div. 1993)).

[158]*Picard*, 462 B.R. at 453-54.

[159]*Id.* at 454. The court has since held that payments by Madoff of fictitious profits above the principal invested were not taken for value under section 548(c), despite the brokerage statements. Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 476 B.R. 715, 725 (S.D.N.Y. 2012).

[160]Gowan v. Patriot Grp., LLC (*In re* Dreier LLP), 452 B.R. 391 (Bankr. S.D.N.Y 2011).

[161]*Id.* at 401.

[162]*Id.* at 437.

[163]*Id.* at 425.

also be seen, albeit in very narrow circumstances, outside the Ponzi-scheme context. *ASARCO LLC v. Americas Mining Corp.*[164] involved a sale by the debtor of its prized assets (stock in a Peruvian mining concern called SPCC) to its parent company, AMC/Grupo, the proceeds of which the debtor used to repay select creditors. The trustee sought to unwind the asset sale, not the debt repayments. But the debtor's use of the proceeds to make debt repayments became critical to the question whether the debtor entered into the transaction with actionable intent. The court found that the relevant facts were indeed indicative of fraudulent intent, in part because "the only creditors who received any of the proceeds of the SPCC stock transfer" were the debtor's parent, AMC/Grupo, and a single class of bondholders who had the power to block the transaction if they were not repaid.[165] AMC/Grupo pointed to other facts that it claimed negated an inference of fraudulent intent, primarily that "some creditors benefitted from the transfer."[166] In essence, the court observed, "AMC contends that ASARCO's claim is not one for fraudulent transfer, but one for improper preference, which was not pled."[167]

After reviewing the case law, the *ASARCO* court agreed that "an intent to prefer one creditor over others is not, *standing alone*, enough to prove that the debtor had the intent to hinder, delay, or defraud any creditors."[168] The court added, however, that it "did not uncover any authority indicating that a plaintiff can never prove an intent to hinder, delay, or defraud creditors if some of the debtor's creditors benefitted from the transaction."[169] Thus, while the fact that some creditors were better off after the transaction "might constitute some evidence that the debtor did not have the intent to hinder, delay, or defraud his creditors," that alone was "not a bar to an actual-intent fraudulent transfer claim."[170]

Ultimately, the court concluded that AMC/Grupo was liable under Delaware's fraudulent transfer statute,[171] and ordered the return of the transferred SPCC stock to the debtor plus damages.[172] In doing so, the court relied on numerous factors, including that the transfer was to ASARCO's controlling shareholder, whose primary goal was "to protect its interest in

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[164] ASARCO LLC v. Ams. Mining Corp. 396 B.R. 278 (S.D. Tex. 2008).

[165] *Id.* at 375-76.

[166] *Id.* at 388-89.

[167] *Id.* at 389.

[168] *Id.* at 391 (emphasis added).

[169] *Id.*

[170] *Id.*

[171] *Id.* at 394.

[172] *See generally* ASARCO LLC v. Ams. Mining Corp., 404 B.R. 150 (S.D. Tex. 2009) (considering remedies in light of earlier findings of liability).

SPCC" from creditor claims in light of the debtor's liquidity crisis.[173] Although the transfer avoided in *ASARCO* was *not* itself a debt repayment, *ASARCO* is noteworthy for its conclusion that a transfer can, in extraordinary circumstances, be made with the requisite intent to hinder, delay, or defraud creditors even if creditors are repaid and are not harmed as a result.

4. *Reconciling the divergent cases: the distinction between preferential and fraudulent intent*

There is some tension between, on the one hand, cases such as *Boston Trading* that draw a strict distinction between preferential and fraudulent transfers and, on the other hand, cases such as *Gowan* and *Picard* that have permitted debt repayments to be challenged as fraudulent transfers. Despite these different approaches, however, a principle that pervades the case law is that the mere intent to prefer one creditor over another, by using scarce resources to satisfy one obligation rather than a competing obligation, is *not* sufficient to establish the intent to hinder, delay, or defraud creditors. As the Supreme Court explained in *Van Iderstine*, the act of preferring one creditor over another is *malum prohibitum*, "innocent and valid . . . unless made within the prohibited period"; to be actionable as a fraudulent transfer, however, the debtor's act must be *malum per se*, "inherently and always vicious."[174] Accordingly, although all preferential debt payments have the incidental effect of harming other creditors by cutting into their potential recoveries, this preferential effect is not "inherently and always vicious," because, as explained by the Supreme Court in *Coder*, it does not involve the debtor "secur[ing] an advantage for himself out of what in law should belong to his creditors, and not to him."[175]

In light of this distinction between an "intent to prefer" and the intent necessary for a fraudulent transfer, avoidance of debt repayments as actual-intent fraudulent transfers has been reserved for the highly unusual situations in which repayments of debts are themselves an integral part of a scheme to benefit the debtor and its shareholders at the expense of creditors who should have priority to the debtor's value. The Ponzi-scheme cases dominate this area. These courts conclude that when the debtor is incurring and repaying debts as part of a continuous criminal fraud, the debtor's motive in satisfying obligations differs from a mere "intent to prefer." A notable aspect of the Ponzi-scheme cases is that the debtor's original transactions with investors

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[173] *ASARCO*, 396 B.R. at 374-75.

[174] Van Iderstine v. Nat'l Discount Co., 227 U.S. 575, 582 (1913).

[175] Coder v. Arts, 213 U.S. 223, 241 (1909) ("In a preferential transfer the fraud is constructive or technical, consisting in the infraction of that rule of equal distribution among all creditors, which it is the policy of the law to enforce when all cannot be fully paid. In a fraudulent transfer the fraud is actual, the bankrupt has secured an advantage for himself out of what in law should belong to his creditors, and not to him." (quoting *In re* Maher, 144 F. 503, 509 (D. Mass. 1906))).

are themselves fraudulent, and the debtor's obligations to those investors are in the nature of restitution claims. To state the obvious, a Ponzi-scheme operator does not repay particular investor-victims because it recognizes that it owes restitution; rather, the payments are made precisely to prevent other investors from discovering and asserting their restitution claims. The payments, in other words, help the debtor and its principals conceal and evade obligations to creditors.

The result in *ASARCO* can likewise be explained based on this distinction between an "intent to prefer" and the more "vicious" intent required for a fraudulent transfer. In *ASARCO*, the court found that the debtor's sale of "crown jewel" assets to its parent company, even though resulting in the repayment of valid debts, was part of a scheme to harm creditors as a whole. What *ASARCO* has in common with the Ponzi-scheme cases, and with *Dean v. Davis*, is that, in all of these cases, the transactions at issue directly benefited the debtor or its shareholders, the hallmark of a fraudulent transfer. In all of those cases, the primary intent of the relevant debt repayments was not to satisfy a valid obligation, but instead to facilitate or conceal a transfer of valuable estate property for the benefit of someone whose interests, as a matter of insolvency law, are legally subordinate to the interests of creditors.

At the same time, unlike the Ponzi-scheme cases, *ASARCO* arguably blurs the distinction between preferential and fraudulent intent. Although *ASARCO* could have rested its decision on specific evidence of an intent to harm creditors that was present in that case,[176] including the benefits realized by the debtor's owner, the court stated more broadly that "a transfer may be made with fraudulent intent even though the debtor did not intend to harm creditors but knew that by entering the transaction, creditors would *inevitably* be hindered, delayed, or defrauded."[177] Viewed in isolation, this definition of "fraudulent intent" could apply to a broad category of transactions.

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[176]In a separate decision addressing damages, the court summed up the most significant factors supporting a finding of intent to hinder or delay, several of which were unrelated to the preferential treatment of non-insider creditors: "(1) the SPCC stock was ASARCO's 'crown jewel', which AMC/Grupo intended to isolate from ASARCO's creditors; (2) almost all of the consideration for the SPCC stock was used to benefit AMC/Grupo and/or was used to satisfy 'key creditors', i.e., those creditors who needed to be paid in order to close the transaction or who held a debt guaranteed by AMC/Grupo; (3) AMC/Grupo refused to expose the SPCC stock to outside bidders; (4) AMC/Grupo actively concealed relevant information concerning the transaction from ASARCO's independent directors, [a financial advisor consulting on the transaction], and the Department of Justice; (5) AMC closed the transaction over the objection of the independent directors; (6) AMC paid [a select set of overdue bonds] at par and with interest over the objections of many, including outside counsel, at a time when ASARCO was starved for cash, and with indifference to the impact this would have on ASARCO's other creditors; and (7) AMC/Grupo created separate bank accounts to hold the consideration received from the transfer for the sole purpose of avoiding garnishment by ASARCO's creditors." ASARCO LLC v. Ams. Mining Corp., 404 B.R. 150, 158-59 (S.D. Tex. 2009) (citations omitted).

[177]ASARCO, 396 B.R. at 386-87 (emphasis added).

Courts have long recognized that the inevitable consequence of most preferential payments is harm to non-preferred claimants: "[o]ne cannot wish to favor some creditors, without also wishing (perhaps regretfully) to treat others with disfavor."[178] And yet, as discussed above, cases for a hundred years have agreed that "the fact that a transfer operates incidentally to hinder or delay creditors is not 'in itself' sufficient to make it void."[179]

Against this backdrop, the First Circuit's decision in *Boston Trading* can also be reconciled, at least to some extent, with the cases that have permitted fraudulent-transfer challenges to debt repayments. *Boston Trading* held that a debtor's repayment to a creditor using the proceeds of fraudulent churning activity was not subject to avoidance as a fraudulent transfer, despite the creditor's alleged knowledge of the debtor's misconduct. But unlike in *ASARCO* or in the Ponzi-scheme cases, the court in *Boston Trading* did not find that the debt repayment was itself essential to a broader scheme to benefit the debtor's shareholders at the expense of creditors. Rather, the court emphasized that the debt at issue was incurred legitimately, outside the context of the debtor's illegal churning.[180] The appellate decisions in *B.E.L.T.* and *Sharp* are similar in this regard, in that (unlike in Ponzi-scheme cases) the specific payments at issue were viewed by the courts as divisible from the debtor's fraudulent activity.[181]

In summary, despite differences in the formulation of the controlling rule, an enduring principle that emerges from a century of decisions is that an "intent to prefer"—i.e., knowledge that a debt repayment will permit one creditor to recover more than others—is fundamentally distinct from an intent to hinder, delay, or defraud creditors. In rare situations, in particular those involving Ponzi schemes, debt repayments have been avoided as intentionally fraudulent because they were integral to broader schemes that, although including preferential transfers, were designed to enrich the debtor at the expense of creditors. In those narrow circumstances, avoidance of the challenged transaction could be said to have served the traditional goal of fraudulent transfer law: ensuring that value was not diverted from the creditor body to someone with a subordinate claim on the debtor's assets, such as

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[178]Richardson v. Germanic Bank of City of N.Y., 263 F. 320, 322 (2d Cir. 1919).

[179]*Id.* at 324.

[180]*See* Boston Trading Grp., Inc. v. Burnazos, 835 F.2d 1504, 1510-11 (1st Cir. 1987) (recognizing that Burnazos was a "legitimate" creditor, and that the fraud in question did not concern the transfer to Burnazos, but the manner in which the funds to repay Burnazos were obtained).

[181]*See* Sharp Int'l Corp. v. State St. Bank & Trust Co. (*In re* Sharp Int'l Corp.), 403 F.3d 43, 56 (2d Cir. 2005) ("The fraud alleged in the complaint relates to the manner in which Sharp obtained new funding from the Noteholders, not Sharp's subsequent payment of part of the proceeds to State Street."); B.E.L.T., Inc. v. Wachovia Corp., 403 F.3d 474, 478 (7th Cir. 2005) ("Plaintiffs contend . . . that Lacrad used false financial statements to conceal [its] true financial status, but this has nothing to do with its motive in paying First Union." (internal quotation marks omitted)).

a shareholder. By contrast, debt repayments are *not* avoidable as fraudulent transfers based on their incidental effect on recoveries of non-preferred creditors; if they were, fraudulent transfer law would infringe upon the statutory scheme enacted to address preferences.

III. THE ROLE OF THE "GOOD FAITH" DEFENSE

As discussed in Part I, section 548(c) of the Bankruptcy Code and analogous provisions in state law provide a defense to fraudulent transfer liability—by permitting the transferee to retain, or hold a lien on, the transferred assets—to the extent the transferee gave "value" for the transfer in "good faith."[182] On the premise that the satisfaction (or securing) of a debt constitutes an exchange of value up to the face amount of the debt, these statutory provisions protect creditor-transferees who can show that they acted in good faith.[183]

The good faith defense is critical to any analysis of whether debt repayments can be challenged as fraudulent transfers because, where applicable, it protects transferees irrespective of the debtor's intent. Thus, while Part II focused on the question of when the *debtor-transferor* has a sufficiently culpable state of mind for a debt repayment to be considered a fraudulent transfer, here the focus turns to the remaining question: if the debtor acted with the requisite intent, when does the *creditor-transferee* also act in bad faith such that it has no defense to liability? As discussed below, there is no uniformly accepted answer to this question. But how courts define "good faith" is closely related to the historical distinction between preference law and fraudulent transfer law.

A. "Objective" versus "subjective" good faith

"Good faith" is not statutorily defined, and it has been called a "vague concept that defies precise definition."[184] Nonetheless, the "clear trend" since

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[182] 11 U.S.C. § 548(c). As discussed above, *see supra* note 44, the Bankruptcy Code likewise prohibits the trustee from recovering from a subsequent transferee "that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided." *Id.* § 550(b). Courts have held that "[t]he good faith standard applicable to immediate and mediate [i.e., subsequent] transferees should be the same as the good faith standard for initial transferees." Goldman v. Capital City Mortg. Corp. (*In re* Nieves), 648 F.3d 232, 239 (4th Cir. 2011).

[183] Section 548(c) provides an affirmative defense on which the transferee bears the burden of proof. *E.g.*, Gowan v. Patriot Grp., LLC (*In re* Dreier LLP), 452 B.R. 391, 426 (Bankr. S.D.N.Y. 2011). Section 278 of the DCL and section 8 of the UFTA likewise impose the burden of proof on the defendant. *See id.* at 434 (New York law); *ASARCO*, 396 B.R. at 425 (UFTA).

[184] Meoli v. Huntington Nat'l Bank (*In re* Teleservices Grp., Inc.), 444 B.R. 767, 795 (Bankr. W.D. Mich. 2011); *see also* Christian Bros. High School Endowment v. Bayou No Leverage Fund, LLC (*In re* Bayou Grp., LLC), 439 B.R. 284, 309 (S.D.N.Y. 2010) ("[C]ourts have struggled in applying this term, and the case law discussing Section 548(c)'s good faith affirmative defense is marked by a lack of clarity if not outright confusion.").

the adoption of the Bankruptcy Code "has been towards an *objective interpretation* of good faith."[185] Under this interpretation, a transferee lacks good faith "if the circumstances would place a reasonable person on inquiry of a debtor's fraudulent purpose, and a *diligent* inquiry would have discovered the fraudulent purpose."[186]

Other courts have concluded that "good faith" has an "objective" *and* a "subjective" component. As the Fourth Circuit recently explained, "[u]nder the subjective prong, a court looks to 'the honesty' and 'state of mind' of the party acquiring the property. Under the objective prong, a party acts without good faith by failing to abide by routine business practices."[187] Under this hybrid test, the transferee's diligence and level of care are still relevant: "a court is required to consider whether the transferee actually was aware or *should have been aware*, at the time of the transfers and in accordance with routine business practices that the transferor-debtor intended to 'hinder, delay, or defraud'" creditors.[188]

The Tenth Circuit's decision in *Jobin v. McKay (In re M & L Business Machine Co.)*,[189] a case involving a Ponzi scheme, has been called "the one case that sets out an explanation" for the objective good faith test.[190] In adopting the objective test, the Tenth Circuit distinguished a previous case in which it held that "good faith"—for purposes of Colorado's Uniform Fiduciary Act—refers to "a thing done 'honestly, whether it be done negligently or not,'" such that "[t]he mere failure to make inquiry, even though there are suspicious circumstances, does not constitute bad faith" unless there is a conscious turning away.[191] In declining to import this interpretation of "good faith" into the fraudulent transfer context, the court observed that the Uniform Fiduciary Act is premised on "the need for uniform rules to take the place of diverse and conflicting rules that had grown up concerning constructive notice of breach of fiduciary obligations in order that commerce might

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185 *Teleservices*, 444 B.R. at 795 (emphasis added); *see also* Jobin v. McKay (*In re* M & L Bus. Mach. Co.), 84 F.3d 1330, 1338 (10th Cir. 1996) ("Significantly, the majority of bankruptcy courts construing 'good faith,' as it is used in § 548(c), have followed the Eighth and Ninth Circuits, holding that a transferee who reasonably should have known of a debtor's insolvency or of the fraudulent intent underlying the transfer is not entitled to the § 548(c) good faith defense." (citing, *e.g.*, Hayes v. Palm Seedlings Partners-A (*In re* Agric. Research & Tech. Grp., Inc.), 916 F.2d 528, 536 (9th Cir. 1990); Brown v. Third Nat'l Bank (*In re* Sherman), 67 F.3d 1348, 1355 (8th Cir. 1995)).

186 *Jobin*, 84 F.3d at 1338; *accord, e.g.*, *Bayou*, 439 B.R. at 312-13; Bear, Stearns Secs. Corp. v. Gredd (*In re* Manhattan Inv. Fund Ltd.), 397 B.R. 1, 22-23 (S.D.N.Y. 2007).

187 Gold v. First Tenn. Bank Nat'l Ass'n, 743 F.3d 423, 430 (4th Cir. 2014) (quoting Goldman v. City Capital Mortg. Corp. (*In re* Nieves), 648 F.3d 232, 239-240 (4th Cir. 2011)).

188 *Id.* (emphasis added).

189 *Jobin*, 84 F.3d 1330.

190 Paul Sinclair, *The Sad Tale of Fraudulent Transfers (Part II): When Did Ponzi Preferences Morph into Fraudulent Transfers?*, 28 AM. BANKR. INST. J. 44, 66-67 (2009).

191 Richards v. Platte Valley Bank, 866 F.2d 1576, 1582-83 (10th Cir. 1989).

proceed with as little hindrance as possible."[192] The court went on: "In the instant case—in which a bankruptcy trustee seeks to recover assets for the benefit of all creditors of a Ponzi scheme—the need for a good faith standard that removes hindrances to commerce is not the paramount concern."[193] The court punctuated this statement with a citation of an earlier decision in which it stated that "[i]t is the ultimate aim of the *preference law* in the Bankruptcy Code to insure that all creditors receive an equal distribution from the available assets of the debtor."[194]

Although the objective test (or a test that includes an objective element) has garnered a majority following,[195] several cases have departed from this trend. For example, in the same decision in which he held that transfers out the Madoff Ponzi scheme were intentional fraudulent transfers, despite satisfying debts, United States District Judge Rakoff of the Southern District of New York held that the good faith defense would apply unless there was "willful blindness" on the part of the defendant to fraudulent conduct (or some more egregious level of culpability).[196] Similarly, in a decision arising out of the Marc Dreier fraud, the bankruptcy court—without deciding the issue—questioned whether "conscious turning away," a formulation used in several Second Circuit cases applying New York law, may be the appropriate standard for good faith rather than "inquiry notice."[197] In doing so, the *Dreier* court noted that Professor Glenn, in his 1940 treatise, adopted a similarly broad view of good faith, stating that "[i]t comes always to a question of the grantee's good faith *as distinct from mere negligence*" and that "[t]here must be a conscious turning away from the subject."[198] In a subsequent decision arising out of the Dreier fraud, a different bankruptcy judge concluded that "conscious turning away" *is* the applicable test for lack of "good faith" for purposes of section 278 of the New York DCL, whereas an "inquiry notice"

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[192]*Jobin*, 84 F.3d at 1337 (internal quotation marks omitted).

[193]*Id.*

[194]*Id.* (emphasis added) (citing and quoting Gill v. Winn (*In re* Perma Pac. Props., Inc.), 983 F.2d 964, 968 (10th Cir. 1992)).

[195]*Jobin*, 84 F.3d at 1336; *accord* Craig T. Lutterbein, *"Fraud and Deceit Abound" but Do the Bankruptcy Courts Really Believe Everyone Is Crooked: The Bayou Decision and the Narrowing of "Good Faith,"* 18 AM. BANKR. INST. L. REV. 405, 437 (2010).

[196]*See* Picard v. Katz, 462 B.R. 447, 455-56 (S.D.N.Y. 2011). In requiring at least "willful blindness" in the *Madoff* case, the court heavily emphasized the debtor's status as a securities broker and the fact that the proceeding was governed by the Securities Investor Protection Act, which is part of federal securities law. *Id.* As a result, the applicability of the *Picard* ruling to other cases is unclear. *See also* Securities Investor Protection Corp. v. Bernard L. Madoff Inv. Sec. LLC, — F. Supp. 2d —, 2014 WL 1651952 (S.D.N.Y. Apr. 27, 2014) (Judge Rakoff reaffirming the "willful blindness" standard in the Madoff/SIPA context).

[197]*See* Gowan v. Patriot Grp., LLC (*In re* Dreier LLP), 452 B.R. 391, 446-51 (Bankr. S.D.N.Y. 2011) (quoting HBE Leasing Corp. v. Frank, 48 F.3d 623, 637 (2d Cir. 1995)).

[198]1 GLENN, *supra* note 5, § 304 (emphasis added), quoted in *Gowan*, 452 B.R. at 450.

test applies under section 548(c) of the Bankruptcy Code.[199]

The most expansive decision challenging the objective test is *Meoli v. Huntington National Bank (In re Teleservices)*.[200] In that case, a trustee sued a bank to recover payments made by the debtor on a revolving credit line using fraudulently obtained funds.[201] In analyzing whether the bank received the payments in good faith, Judge Hughes conducted a broad review of the good faith defense and case law interpreting it.[202] The court demonstrated that the so-called "objective" test originated not from an authoritative source but in large part from a case interpreting the law of the Dakota Territory, which contained an express statutory provision imputing constructive knowledge to those who did not exercise "reasonable diligence" when faced with facts that would put "a prudent man" on "inquiry."[203] The court also focused on the Supreme Court's decisions in *Coder*, *Van Iderstine*, and *Dean*, and on the "fundamental distinction" drawn in those cases "between the recovery of actually fraudulent transfers," which are *malum per se*, "and the recovering of other avoidable transfers on the other hand," which are "only *malum prohibitum*."[204] The court observed that in *Coder*, *Van Iderstine*, and *Dean*, the Supreme Court ultimately turned its focus to the question whether the *transferee* acted appropriately, and concluded that "the recipient's accountability to the estate is to be gauged based upon the same notion that [an actual-intent fraudulent transfer] is *malum per se*."[205] In addition, the *Teleservices* court observed that the Bankruptcy Act of 1898, as amended in 1938 by the Chandler Act, provided a defense to transferees that provided "fair equivalent" value "without actual fraudulent intent," a formulation that was replaced in 1978 by "good faith," but without any indication that the basic

[199] *See* Gowan v. Westford Asset Mgmt. LLC (*In re* Dreier LLP), 462 B.R. 474, 491-92 (Bankr. S.D.N.Y. 2011). For a discussion of the difference between willful blindness and inquiry notice, see, for example, Fraternity Fund Ltd. v. Beacon Hill Asset Mgmt., LLC, 479 F. Supp. 2d 349, 368 (S.D.N.Y. 2007) ("Conscious avoidance . . . involves a culpable state of mind whereas constructive knowledge imputes a state of mind on a theory of negligence.").

[200] Meoli v. Huntington Nat'l Bank (*In re* Teleservices Grp., Inc.), 444 B.R. 767 (Bankr. W.D. Mich. 2011).

[201] *Id.* at 774-88.

[202] Notably, the revolving credit line was not in fact extended to the debtor, and the court rejected an argument that the debtor and the borrower were alter egos. 444 B.R. at 788-90. As a result, as the court acknowledged, the bank did not provide "value" to the debtor, and the court thus was "not required to make any further determination with respect to [the bank's] Section 548(c) defense," meaning that the relevant discussion was dicta. *Id.* at 790.

[203] *See id.* at 796-800 (tracing history of objective standard to Shauer v. Alterton, 151 U.S. 607 (1894)); *accord* Paul Sinclair, *The Sad Tale of Fraudulent Transfers: The Unscrupulous Are Rewarded and the Diligent Are Punished*, 28 AM. BANKR. INST. J., 16, 79-80 (2009).

[204] *Id.* at 803; *see also* Sinclair, *supra* note 190, at 44 (criticizing the "objective test" for expanding the meaning of bad faith to the point that "claims that have historically been considered 'preferences' will then become 'fraudulent transfers' under state and federal statutes").

[205] *Teleservices*, 444 B.R. at 802-03.

scienter standard would change.[206]

Ultimately, the *Teleservices* court concluded that the objective test adopted in recent years represents an unjustified departure from the traditional understanding of the term "good faith," which focused on a person's state of mind and "honesty and integrity."[207] Instead, the court articulated a subjective test under which a *transferee*'s good faith is evaluated based on its awareness of the same "badges of fraud" that are often used to evaluate whether a *transferor* has acted with intent to hinder, delay, or defraud creditors.[208] The court further concluded that, because "actual knowledge" of such badges of fraud will be difficult to prove, "willful blindness" is sufficient to show bad faith. Applying this test, the court found that the lender was liable to return debt repayments it accepted from the time it "turned a blind eye to the mounting evidence" that the debtor was engaged in a fraud.[209] Notably, the court recognized that the bank "never actually knew of the massive fraud that Teleservices was perpetrating upon its creditors."[210] Rather, the court concluded that the relevant facts—including mounting evidence that the borrower was not using its receivables to pay down the facility, as was represented, and the fact that a bank employee had learned that the borrower's CEO was a convicted felon—precluded the bank from demonstrating its good faith as to the later repayments.[211]

B. The objective good faith test: conceptual problems

A majority of courts—including appellate courts—have analyzed "good faith" based on an objective test. The results of this objective test, as applied by fact-finders, have varied. For example, in trials held in New York arising out of two different hedge-fund frauds, juries reached contrary conclusions as to whether investors in the funds had acted in good faith in connection with transfers by the funds.[212]

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[206] *Id.* at 804. The language of the Chandler Act ("without actual fraudulent intent") comes from the UFCA and is still in New York's DCL in section 278(2).

[207] *Teleservices,* 444 B.R. at 815 ("[The] Trustee's sweep, though, is much too broad [in urging a standard of inquiry notice], for it undermines the traditional notions of honesty and integrity that have been associated with the recovery of fraudulent transfers since *Coder*, *Van Iderstine*, and *Dean*."); *see also id.* at 843 ("[T]he assessment is to be based upon a subjective, rather than an objective, standard—to wit, whether the transferee conducted himself honestly and with integrity (i.e., in good faith) as he reacted to his suspicions.").

[208] *Id.* at 813-14.

[209] *Id.* at 830.

[210] *Id.* at 824.

[211] *Id.* at 822-30.

[212] *See* Joel Rosenblatt, *Bayou Group Estate Wins $13 Million From Hedge Funds for Fraud Investors*, Bloomberg, May 12, 2011 (reporting that the jury in the fraudulent-transfer lawsuits in *In re Bayou Group, LLC* "found the [hedge-fund defendants] failed to prove that they had, in good faith, conducted a diligent investigation of the Bayou fraud before withdrawing their principal investment"); Tiffany Kary, *Bear Stearns Wins Trial Over Hedge Fund's Collapse*, Bloomberg, June 27, 2008 (reporting that the jury in

The meaning of "good faith," however, is by no means settled. The recent decisions challenging the objective good faith test, including *Teleservices*, expose flaws in that test that have not been adequately addressed. On the simplest level, it is difficult to reconcile the concept of "good faith" with a test that focuses on "inquiry notice" and the adequacy of a creditor's due diligence. The word "faith," by definition, refers to a person's subjective thought process.[213] More importantly, the term "good faith," as used in various areas of the law, connotes honesty and fair dealing, not observance of a duty of care.[214] For example, the Uniform Commercial Code generally defines "good faith" as "honesty in fact."[215] Consistent with this definition, the Second Circuit has concluded that the U.C.C.'s standard of good faith "does not impose a standard of care but, rather, a standard of *fair dealing*."[216]

As another example, Delaware corporate law imposes a duty of good faith as a component of the directors' duty of loyalty, separate from the directors' duty of care.[217] The Delaware Supreme Court has explained that "[a] failure to act in good faith may be shown, for instance, where the fiduciary *intentionally* acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the *intent* to violate applicable positive law, or where the fiduciary *intentionally* fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."[218]

Beyond the plain meaning of the words, the limited justifications that have been provided for the objective good faith test are not compelling. *Jobin*, the Tenth Circuit case that defended the objective test, involved guaranteed Ponzi-scheme returns of 120% per year on some investments and

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the fraudulent transfer action in *In re Manhattan Investment Fund Ltd.* found that the defendant acted in good faith in receiving repayments from Ponzi scheme because it "was diligent with respect to its inquiries" into the debtor).

[213] *See, e.g.*, MERRIAM-WEBSTER INC., WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 446 (Frederick C. Mish et al. 1988) (defining "faith" as "sincerity of intentions").

[214] *See* BLACK'S LAW DICTIONARY 713 (8th ed. 2004) (defining "good faith" as "[a] state of mind consisting in (1) honesty in belief or purpose, (2) faithfulness to one's duty or obligation, (3) observance of reasonable commercial standards of fair dealing in a given trade or business, or (4) absence of intent to defraud or to seek unconscionable advantage"); *see also* Interpool Ltd. v. Patterson, 890 F. Supp. 259, 266 (S.D.N.Y. 1995) ("A conveyance is not made in good faith under Section 272 [of the New York DCL] when any of the following factors is missing: (i) an honest belief in the propriety of the activities in question; (ii) no intent to take unconscionable advantage of others; and (iii) no intent to, or knowledge of the fact that the activities in question will, hinder, delay or defraud others.").

[215] *E.g.*, N.Y. U.C.C. § 1-201(19) (McKinney 2001). Article 2 of the U.C.C. separately defines the term "good faith," as applicable to a "merchant," to mean "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade." *Id.* § 2-103(1)(b).

[216] J. Walter Thompson, U.S.A., Inc. v. First BankAmericano, 518 F.3d 128, 139 (2d Cir. 2008) (rejecting claim against bank that mistakenly honored altered check because, even if the bank were negligent, the absence of "dishonesty" or unfair dealing precluded a finding of bad faith).

[217] *See, e.g.*, Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006).

[218] *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 67 (Del. 2006) (emphasis added).

468% per year on others.[219] Given these extreme facts, the court would likely have found bad faith even under a subjective standard.[220] In adopting the objective test, however, the Tenth Circuit in *Jobin* invoked the goal of *preference* law, namely equality of distribution.[221] The court did not consider whether an objective good faith test, especially in the context of a debt repayment, was consistent with the goal of *fraudulent transfer* law, namely remedying unfair diminution of the debtor's estate.

The *Jobin* court's focus on preference law is divorced from the relevant statutes, under which good faith is a defense to fraudulent transfer claims but not to preference claims. As shown in *Teleservices*, the traditional focus of fraudulent transfer law, as opposed to preference law, has been on the states of mind of both the debtor and the transferee: *Coder*, *Van Iderstine*, and *Dean* each required malice toward creditors to be present on *both* sides of the transaction.[222] An objective good faith test rooted in concepts of negligence departs from this approach, making actual-intent fraudulent transfers less *malum per se* and more *malum prohibitum*—avoidable on the basis that they frustrate a policy goal, not because the transferee is morally deserving of being forced to forfeit property (for which it provided value).

Although some courts have tried to address these problems with the objective good faith test by limiting its application to section 548(c) of the Bankruptcy Code and applying a "conscious turning away" test under New York law,[223] there is not a clear-cut basis to distinguish between "good faith" in section 548(c) and the same term in section 278(1) of the DCL. Section 548(c) provides a defense for transferees to the extent they give value in "good faith"; section 278(1) of the DCL (section 9 of the UFCA) likewise provides a defense to transferees that give "fair consideration," which is defined to include "fair equivalent" value and "good faith." Section 548 has been

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[219]Jobin v. McKay (*In re* M & L Bus. Mach. Co.), 84 F.3d 1330, 1338-39 (10th Cir. 1996).

[220]*See also* Craig T. Lutterbein, *supra* note 195, at 437-44 (making a similar observation as to other leading cases on the objective standard).

[221]*Jobin*, 84 F.3d at 1337 ("It is the ultimate aim of the preference law in the Bankruptcy Code to insure that all creditors receive an equal distribution from the available assets of the debtor." (quoting Gill v. Winn (*In re* Perma Pac. Properties, Inc.), 983 F.2d 964, 968 (10th Cir.1992))).

[222]Meoli v. Huntington Nat'l Bank (*In re* Teleservices Grp., Inc.), 444 B.R. 767, 803 (Bankr. W.D. Mich. 2011) ("[T]he Court recognized that the transferee's good faith—i.e., his own behavior regarding the fraud being perpetrated—would be dispositive of whether he would have to return a transfer by the debtor that had been fraudulently intended."); *see also* Marie T. Reilly, *A Search for Reason in "Reasonably Equivalent Value" After* BFP v. Resolution Trust Corp., 13 AM. BANKR. INST. L. REV. 261, 264 (2005) ("Because the remedy of transfer avoidance is meted out against the transferee . . . the complicity of the transferee in the scheme was at least equally important to the debtor's fraudulent purpose.").

[223]*See, e.g.*, Gowan v. Westford Asset Mgmt. LLC (*In re* Dreier LLP), 462 B.R. 474, 491-92 (Bankr. S.D.N.Y. 2011) (holding that standard of good faith under New York law requires conscious turning away and "is more subjective than the corresponding good faith defense under 11 U.S.C. § 548(c)," which focuses on inquiry notice).

described as the "federal enactment of the Uniform Fraudulent Conveyance Act,"[224] and the language and structure of the provisions are thus very similar.[225]

C. The subjective good faith test: open questions

Since the subjective good faith test has rarely been adopted, its contours have not been well-defined. *Teleservices*, the case with the most extensive treatment of the subjective test, raises two questions that are particularly relevant to situations involving debt repayments. The first concerns the level of culpability that should tip the scales from good faith to bad. Is willful blindness toward badges of fraud, including the debtor's weak financial condition, sufficient to demonstrate bad faith? The second question, related to the first, concerns *when* the defendant's state of mind should be evaluated. Should good faith be assessed at the time the defendant extended credit or made an investment, or should the inquiry focus on when the challenged repayment was made?

Judge Hughes's decision in *Teleservices* addressed each of these questions. As to culpability, the *Teleservices* court determined that it would impose liability if the bank was willfully blind to the same badges of fraud used in evaluating a transferor's intent.[226] The court further explained that "the recognition that *some duty of inquiry* is imposed upon the transferee inevitably leads to an evaluation of what the transferee did (or, as is often the case, did not do) when one badge of possible fraud was apparent and other badges were discoverable."[227] Applying this approach, the *Teleservices* court assessed the transferee's state of mind as of *the time it was repaid*—not "retroactively"—and concluded that the bank, although ignorant of the debtor's fraud when it extended credit and began to receive payments, eventually "turned a blind eye" to badges of fraud, such that repayments of the facility after that point were recoverable as actual-intent fraudulent transfers.[228] Notably, the *Teleservices* court did not distinguish among different badges of fraud. While *Teleservices* itself involved willful misconduct by the debtor, the decision can be read to suggest that a creditor's knowledge of the debtor's insolvency or undercapitalization triggers the same duty of inquiry.

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[224] Levin, *supra* note 74, at 180; *see also id.* at 182 ("As under current law, a good-faith transferee or obligee that takes for value is protected under the Code to the extent of the value given.").

[225] *See* Silverman v. Actrade Capital, Inc. (*In re* Actrade Fin. Techs. Ltd.), 337 B.R. 791, 809 (Bankr. S.D.N.Y. 2005) ("Although *Sharp* only directly addressed pleading under the DCL, there is no reason why its reasoning should not be applicable to claims of intentional fraudulent conveyance under the Bankruptcy Code as well, especially as the Federal and State statutes are structured similarly, and there is no difference in burden of proof.").

[226] *Teleservices*, 444 B.R. at 813-14.

[227] *Id.* at 814-15 (emphasis added).

[228] *Id.* at 830.

Although sharply different from the objective good faith test used in other cases, the subjective test formulated in *Teleservices* is also different from the test applied in cases such as *Boston Trading* and *Sharp International*. As discussed above, in evaluating "good faith" under the UFCA's constructive fraud provision, the First Circuit in *Boston Trading* distinguished between a creditor's actual *participation* in the debtor's misconduct and *knowledge* of such misconduct at the time of repayment. It concluded that "[t]o find a lack of 'good faith' where the transferee does not participate in, but only knows that the debtor created the other debt through some form of, dishonesty is to void the transaction because it amounts to a kind of 'preference.'"[229] The court went on: "[t]o say this is not to leave the words 'good faith' without meaning. A court might refer to a lack of good faith, for example, where the transferee *participates in the original dishonesty*, say, by providing the debtor with goods that he uses to convince a creditor to advance new money, which he wrongfully intends to steal."[230] The Second Circuit agreed with this distinction in *Sharp International*, concluding that "a lack of good faith 'does not ordinarily refer to the transferee's knowledge of the source of the debtor's monies which the debtor obtained at the expense of other creditors.'"[231] Thus, despite the analysis in *Teleservices* of the distinction between *malum prohibitum* preferential transfers and *malum per se* fraudulent transfers, the court's definition of good faith was decidedly narrower than the definition used in leading cases distinguishing preferential debt repayments from fraudulent transfers.

Teleservices might be distinguished from *Boston Trading* and *Sharp International* because it dealt with the good faith defense to an actual-intent fraudulent transfer claim, not the definition of "fair consideration" in the UFCA's constructive fraudulent transfer provision. As discussed, the broad definition of "good faith" adopted in those cases rested in part on the observation that "the issue of intent is irrelevant" in a constructive fraudulent transfer statute.[232] Yet in any context, the definition of "good faith" adopted in *Teleservices*—under which bad faith will exist if a creditor *receives* a debt repayment while willfully blind to fraud—appears to impose a burden on creditors that does not otherwise exist. As the Third Circuit explained nearly a century ago in *English v. Brown*,[233] there is a crucial difference between a purchaser

[229]Boston Trading Grp., Inc. v. Burnazos, 835 F.2d 1504, 1512 (1st Cir. 1987).

[230]*Id.* (emphasis added).

[231]Sharp Int'l Corp. v. State St. Bank & Trust Co. (*In re* Sharp Int'l Corp.), 403 F.3d 43, 55 (2d Cir. 2005) (quoting *Boston Trading*, 835 F.2d at 1512).

[232]*Id.* at 54 (quoting United States v. McCombs, 30 F.3d 310, 326 n.1 (2d Cir. 1994)).

[233]English v. Brown, 229 F. 34 (3d Cir. 1916) (holding that a transfer by an insolvent to his wife in satisfaction of a legitimate antecedent debt was not avoidable despite the debtor's intent to evade creditors and wife's knowledge thereof).

"for a present consideration" and a purchaser "in satisfaction of a pre-existing debt." The former "is in every sense a volunteer" and may safely "keep out of the transaction," such that if he does enter into the transaction "knowing the fraudulent purpose of the grantor, the law, very properly, says that he enters it for the purpose of aiding that fraudulent purpose."[234] By contrast, as to the one who "takes the property in satisfaction of a pre-existing indebtedness," "[t]he law throws upon him no duty of protecting other creditors. . . . He may know the fraudulent purpose of the grantor, but the law sees that he has a purpose of his own to serve, and if he goes no further than is necessary to serve that purpose, the law will not charge him with fraud by reason of such knowledge."[235] In other words, whatever responsibility a lender or investor may have to investigate a prospective debtor *before* making a loan or other investment that will benefit the debtor, once a loan or investment has been validly made, there is no duty to the debtor or other creditors to investigate suspicions or "red flags" before simply accepting repayment or redeeming.[236]

The approach adopted in *Teleservices* is thus open to question insofar as it exposes creditors to potential liability for accepting repayment of valid debts. There may be policy reasons to impose a burden on creditors not to accept payments in situations such as the one in *Teleservices*: for example, creditors may be more likely to report unlawful conduct to authorities if they cannot expect to retain repayments once they are faced with strong evidence of such misconduct. The test articulated in *Teleservices*, however, is an imperfect tool to achieve those objectives. In situations involving true malfeasance, other sources of law—for example, statutes governing money laundering—operate to deter and prevent banks and other parties from transacting in the "proceeds" of criminal activity.[237] But in situations where a lender is presented with badges of fraud short of purposeful misconduct, such as undercapitalization and insolvency, preventing the lender from accepting and retaining debt repayments serves to deter conduct that, from the lender's standpoint, amounts to no more than a preferential payment, which the lender has no duty to reject or report.

By limiting "bad faith" to situations in which a creditor has actively joined with the debtor in a scheme to harm creditors—in particular, by providing new financing to the debtor despite knowledge (or the equivalent) of the debtor's intentions *at that time*—the approach adopted in *Boston Trading*

[234] *Id.* at 40 (quoting Atl. Ref. Co. v. Stokes, 75 A. 445 (N.J. Ch. 1910)).

[235] *Id.* (quoting Atl. Ref. Co. v. Stokes, 75 A. 445 (N.J. Ch. 1910)).

[236] *See* Gowan v. Patriot Grp., LLC (*In re* Dreier LLP), 452 B.R. 391, 449 (Bankr. S.D.N.Y. 2011) ("Defendants do not appear to have owed a duty to anyone (other than perhaps their own investors) to investigate Dreier's fraud. On the record before the Court it is not clear that the Defendants ever had a duty to investigate further.").

[237] *See* 18 U.S.C. §§ 1956, 1957 (2012).

has the benefit of cohering with common-law duties and expectations. Under common-law principles, a creditor that provides financing to a debtor despite knowledge (or the equivalent) of a scheme to hinder, delay or defraud creditors may be said to aid and abet such a scheme,[238] and it is clearly desirable to deter such conduct. On the other hand, a creditor that simply accepts repayment of that valid debt does not violate a duty to other creditors.[239] Although other bodies of law will in some situations prevent lenders from knowingly accepting the proceeds of intentional fraud, the good faith test adopted in *Teleservices* has the potential to penalize creditors for accepting debt repayments based on knowledge of conduct that may be preferential but is neither criminal nor *malum per se*.

CONCLUSION

The distinction between a preferential transfer and a fraudulent transfer has long been recognized in the law, but the contours of that distinction have been the subject of debate for some time. After more than a century of judicial decisions, what is fairly clear is that a debt repayment to a non-insider generally will not be avoidable as a fraudulent transfer absent proof that the transaction was intended to cause injury to creditors apart from and beyond the hindrance that inevitably results from a preference. Accordingly, outside of situations such as Ponzi schemes—in which debt repayments are themselves wholly inseparable from a broader scheme to harm creditors for the benefit of the debtor—courts have mostly been unwilling to impose fraudulent transfer liability on creditors whose valid debts are repaid, regardless of the creditor's knowledge of the debtor's condition or conduct.

Moreover, even in the narrow set of cases in which debt repayments may be avoidable as fraudulent transfers, the "good faith" defense may provide creditors with a defense to liability, at least with respect to their principal invested. Nonetheless, as a result of the judicial trend in favor of an objective interpretation of "good faith," the good faith defense has not always had that effect. The defense instead has proven unpredictable, and creditors have essentially been required to prove that they acted responsibly in addition to innocently. Returning to a subjective test of a creditor's "good faith" would

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[238] *See, e.g.*, Kottler v. Deutsche Bank AG, 607 F. Supp. 2d 447, 464 (S.D.N.Y. 2009) (elements of a claim for aiding and abetting fraud under New York law are: "(1) the existence of an underlying fraud; (2) knowledge of this fraud on the part of the aider and abettor; and (3) substantial assistance by the aider and abettor in achievement of the fraud," which exists "where a defendant affirmatively assists, helps conceal, or by virtue of failing to act when required to do so enables the fraud to proceed" (citations and internal quotation marks omitted)); *see also* Sharp Int'l Corp. v. State St. Bank & Trust Co. (*In re* Sharp Int'l Corp.), 403 F.3d 43, 49-50 (2d Cir. 2005) (same for aiding and abetting breach of fiduciary duty).

[239] Sharp Int'l, 403 F.3d 43, 51 (2d Cir. 2005) (State Street's "demand for repayment of a bona fide debt is not a corrupt inducement that would create aider and abettor liability" under the "substantial assistance" prong).

be consistent not only with the traditional understanding of that phrase's meaning but also with the policies underlying fraudulent transfer law as opposed to preference law.