

Property Can Be Recovered from Subsequent Transferee Without First Avoiding Fraudulent Transfer to Initial Recipient

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The power of a bankruptcy trustee or a chapter 11 debtor-in-possession ("DIP") to avoid and recover fraudulent transfers can bring significant resources into a debtor's estate. In cases where there is little value remaining for unsecured creditors, recovered assets can be among the most important sources of recovery. Such recovery actions, however, can prove challenging in cases where the transferred property has subsequently been transferred to one or more additional parties. In such complex transactions, a transferee that received a debtor's property may be required to return the asset, or its value, to the debtor's estate, even if the transferee did not receive the property directly from the debtor. The Eleventh Circuit Court of Appeals recently had an opportunity to decide whether a trustee may look for recovery to the ultimate recipients of fraudulently conveyed property without first avoiding the initial transfer. In *In re International Administrative Services, Inc.*, the Eleventh Circuit confronted some of the issues and challenges that face trustees seeking to recover property that a debtor fraudulently transferred through a complicated series of transactions.

Recovery of Fraudulently Transferred Property in Bankruptcy

If a debtor transfers assets or incurs an obligation within one year of filing for bankruptcy (or sometimes earlier), either with the intent to defraud creditors or when it is insolvent and receives inadequate value in exchange, a bankruptcy trustee or DIP can avoid (invalidate) the transfer. In addition, section 550 of the Bankruptcy Code authorizes a trustee or DIP to recover the property

in question or its value. Specifically, section 550(a) provides that "to the extent that a transfer is avoided . . . , the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from — (1) the initial transferee of such transfer or the entity for whose benefit the transfer was made; or (2) any immediate or mediate transferee of such initial transferee."

There are exceptions to a trustee's ability to recover from initial or subsequent transferees of an avoided transfer. Section 550(b) prohibits recovery from any "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."

Thus, actual avoidance of the initial transfer enables a trustee to recover the transferred property from any transferee, initial or otherwise (assuming the absence of a good faith defense).

Notwithstanding the statute's reference to an "avoided" transfer, however, a controversy has developed in the courts concerning the trustee's ability to recover from non-initial transferees where the trustee merely shows that the subject transfer is "avoidable" but does not seek to avoid the transfer. The Eleventh Circuit addressed this uncertainty in *International Administrative Services*.

International Administrative Services

Four years before International Administrative Services, Inc. ("International") filed for chapter 11 protection, the company's founder and sole shareholder Charles Givens hired David Tedder, a self-described expert in shielding assets from creditors, to develop and implement a

plan that would move substantially all of International's assets beyond the reach of its creditors. Between January 1992 and June 1996, under Tedder's asset protection plan, International's assets were transferred to various Tedder-owned entities, some of which were created for the sole purpose of receiving transfers from International. After the initial transfers, the assets were transferred more than 100 times through a complex structure of international transactions that ultimately resulted in the extraction of \$50 million from International. During a two month period in 1993, IBT International, Inc. ("IBT") and California Sunbelt Developers, Inc. ("Sunbelt") received \$1,050,000 in funds as a result of Tedder's asset protection plan. IBT and Sunbelt were real estate development companies owned by one of Tedder's business associates.

After International filed for bankruptcy in 1996, the creditors' committee appointed in the chapter 11 case obtained authority to prosecute the estate's avoidance claims. International's efforts to reorganize soon failed, and the company proposed a liquidating chapter 11 plan under which all avoidance causes of action were entrusted for prosecution to a stock trustee.

The trustee ultimately sued several defendants, including IBT and Sunbelt, seeking to avoid and recover assets transferred by International pre-bankruptcy. At trial, the bankruptcy court found that International, with the assistance of Givens and Tedder, engaged in a complex plan designed to defraud International's creditors. Because of the fraudulent asset protection scheme, IBT and Sunbelt received \$1,050,000 from International. Neither IBT nor Sunbelt received the assets directly from International, but through a series of transactions involving many other mediate or intermediate transferees, the first of which were Tedder's law firm and a company controlled by him. Even so, the bankruptcy court entered judgment against IBT and Sunbelt for approximately

\$1,680,000, representing the amount originally conveyed plus interest. The district court upheld that determination on appeal.

The Eleventh Circuit's Decision

The defendants appealed the district court's decision to the Eleventh Circuit, arguing that section 544 of the Bankruptcy Code — the avoidance vehicle chosen by the trustee — requires avoidance of a conveyance to an initial transferee before property or its value can be recovered from any subsequent transferee under section 550(a)(2). Because the trustee did not bring an action against the initial transferees, the defendants argued that the transferred property could not be recovered from any subsequent transferee. According to the defendants, the plain language of the statute, which provides that a trustee may recover property from transferees "to the extent that a transfer is avoided," clearly means that avoidance must precede recovery. In addition, the defendants relied on *In re Trans-End Tech., Inc.*, where an Ohio bankruptcy court interpreted section 550(a) to require avoidance of an initial transfer as a prerequisite to recovery from subsequent transferees.

The Eleventh Circuit rejected these arguments. It held that a trustee can recover from successive transferees without first avoiding an initial transfer, so long as the trustee demonstrates that the initial transfer is avoidable. Initially, the Court of Appeals considered whether the defendants could be considered initial, rather than subsequent, transferees under the "mere conduit" rule. The mere conduit rule states that a party that receives property from the debtor in good faith with instructions to transfer it to a third party fails to have sufficient dominion and control over the transferred property to be considered the initial transferee. Courts, therefore, consider the party

who receives the property from the conduit as the initial transferee. The Eleventh Circuit, however, found that the mere conduit rule did not apply in this case because the initial transferees did not act in good faith.

The Eleventh Circuit then addressed the defendants' interpretation of the language of section 550(a). Characterizing as "ambiguous" the clause "to the extent that a transfer is avoided," the court looked beyond the statute's plain meaning to determine lawmakers' intent in enacting it. According to the Eleventh Circuit, the strict interpretation of section 550(a) argued by the defendants would require a "bizarre exercise in futility" that was not intended by Congress:

The strict interpretation of § 550(a) produces a harsh and inflexible result that runs counterintuitive to the nature of avoidance actions. If the initial transaction must be avoided in the first instance, then any streetwise transferee would simply re-transfer the money or asset in order to escape liability. The chain of transfers would be endless.

Next, the court found that the weight of authority was against the defendants' interpretation of section 550(a) — the defendants could point to only two cases requiring the actual avoidance of an initial transfer before subsequent transferees are subject to liability under section 550(a) of the Bankruptcy Code. Based upon these considerations, the Eleventh Circuit held that the trustee did not first have to pursue actions against the initial transferees of International's assets to recover transfers made to IBT and Sunbelt.

Analysis

The Eleventh Circuit's adoption of an approach pursuant to which transferred property can be recovered from subsequent transferees once it has been proven that the initial transfer is

"avoidable" — rather than actually avoided — highlights how many courts pragmatically apply the avoidance mechanisms of the Bankruptcy Code. Similar to the mere conduit rule, the "avoidable" approach allows the trustee to skip over the initial transferee, or any mediate transferee, to recover from transferees down the line, as long as the initial transfer is avoidable. The Court of Appeals, however, was careful to emphasize that its approach in no way derogates the conduit theory:

We emphasize that this ruling does not erode the conduit theory. Rather, it accommodates a case involving a multitude of patently fraudulent transfers. Not all cases can conveniently be characterized as involving a "conduit" in order to reach property from later transfers. Thus, the decision today allows a more pragmatic and flexible approach to avoiding transfers; for if the Bankruptcy Code conceives of a plaintiff suing independently to avoid and recover, then bringing the two actions together only advances the efficiency of the process and furthers the "protections and forgiveness inherent in the bankruptcy laws." "The cornerstone of the bankruptcy courts has always been the doing of equity," and in situations such as this, where money is spread throughout the globe, fraudulent transferors should not be allowed to use § 550 as both a shield and a sword.

Other courts have held that a trustee first must actually avoid the initial transfer before seeking recovery against subsequent transferees. It is not certain whether other circuits will follow the Eleventh Circuit's "avoidable" approach. Considering the close relationship between the initial transferees and the subsequent transferees, however, it is possible that *International Administrative Services* will be read narrowly. That is, the result may be different in a similar case where the subsequent transferees are not so closely related to the initial transferees.

In re International Administrative Services, Inc., 408 F.3d 689 (11th Cir. 2005).

In re Trans-End Tech., Inc., 230 B.R. 1010 (Bankr. N.D. Ohio 1998).