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

Part Two of a Two-Part Article

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Last month, we began our discussion of what constitutes a good-faith defense to a fraudulent transfer claim with an initial examination of the recent Sixth Circuit opinion in *Meoli v. Huntington Nat'l Bank*, 2017 U.S. App. LEXIS 2248, *28 (Feb. 8, 2017). We continue the analysis this month by focusing on sub-issues presented in *Meoli*, including the question of notice, the proper test of good faith, and an analysis of whether banks may be considered "transferees" with respect to ordinary bank deposits. In addition, we discuss a recent Ninth Circuit preference decision that offers a mistaken analysis of the transfer issue.

Meoli

In *Meoli*, the trustee, sought to recover fraudulent transfers of funds from the debtor, T, to a bank that lent money to, and maintained the deposits of, another company, C, which had created T to perpetuate a Ponzi scheme. As a part of the scheme, C and T moved the fraud's proceeds between their bank accounts.

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The trustee sought to recover three types of transfers from T: 1) direct loan repayments sent directly to the bank to pay down C's debt; 2) indirect loan repayments, which T sent to C's deposit account at the bank, and which C later used to repay its debt; and 3) excess deposits, which T sent to C's deposit account at the bank, and which C later withdrew or the government later seized. The bankruptcy court held that the trustee could recover all three types of transfers from the bank. The district court agreed.

The U.S. Court of Appeals for the Sixth Circuit accepted the lower court's finding that "a critical breakdown in [the Bank's] internal communications ended its proven good faith on April 30, 2004 [the date a bank investigator discovered a critical clue to C's fraud]." *Id.* at *27. Specifically, the breakdown was that the investigator failed to share his discovery with the bank's manager who oversaw C's account. Thus, the trustee could recover "all subsequent loan repayments," including "some of the indirect loan repayments and all of the direct loan repayments" made after April 30, 2004. *Id.* at *27-*28.

The Court of Appeals also agreed that the Bank's "continued cooperation with the FBI did not cure the corporate bad faith embedded in [the Bank's] breakdown in communication … ." *Id.* at *30. In its view, the Bank's "good faith may end while its employees' good faith … continued" because "its [investigator] failed to share information … with the person whom [the Bank] charged with managing" its relationship with C. *Id.* at *31. The "innocent miscommunication" was immaterial, for the Bank was "ultimately responsible for the investigator's withholding from [the account manager] information that would have truly put [the manager] to the test." *Id.*

As a result, the Trustee was able to recover "all direct loan repayments, of which [the Bank] is an initial transferee" because the Bank received them after April 30, 2004, when it could no longer claim good faith. *Id.* at *32. The trustee was also entitled to recover any indirect loan repayments where the Bank was a subsequent transferee after April 30, 2004. *Id.*

Indirect Loan Repayments

The lower court found that the Bank acted in good faith prior to April 30, 2004, but still held the Bank liable because of its "inquiry notice of [C's] fraud on the earlier date." *Id.* at *32.

It agreed with the Trustee that "inquiry notice constituted 'knowledge of the voidability of the transfers" under Code §550(b)(1), eliminating the Bank's subsequent transferee defense. As noted above, however, the Sixth Circuit disagreed, explaining that "inquiry notice," by itself, "is not necessarily enough in every case." *Id*. at *33.

The court analyzed its two applicable precedents. *In re Nordic Village, Inc*., 915 F.2d 1049, 1056 (6th Cir. 1990) (2-1), rev'd on other grounds, *U.S. v. Nordic Village, Inc*., 503 U.S. 30 (1992) (on facts of that case, "inquiry notice" sufficed for "knowledge of the voidability"); *In re First Independence*, 181 App'x 524, 526 (6th Cir. 2006) (fraudulent principals of debtor deposited checks issued by debtor into their personal accounts at defendant bank, giving bank "inquiry notice," but those facts "would not lead a reasonable person to believe that the transfers were voidable.").

According to the court in *Nordic*, "the transferee failed to prove lack of knowledge of voidability because the facts would have 'placed a reasonable person on notice that the transfer was illegitimate, and by extension that it was voidable.'" *Id*. at *36. The IRS in *Nordic* had received a check from the corporate debtor who instructed it to "credit the payment against the outstanding tax liabilities of the delivering individual." *Id*. at *33, citing 915 F.3d at 1050-51. Because "it is not in an ordinary practice for corporate entities to pay one another's taxes, that irregularity was notice of voidability." *Id*. at *34, citing 915 F. 3d at 1056. In *First Independence*, however, the court held that although "inquiry notice sometimes suffices to 'alert' a reasonable person to voidability, … on different facts [viewed] holistically, a reasonable person may not be alerted to a transfer's voidability even if there was inquiry notice …." *Id*. There were at least two "legitimate scenarios" in *First Independence* that would eliminate "knowledge" of voidability: the checks could have been salary payments, and "any inquiry into the legitimacy of the checks would have been futile" for the debtor's principals would have been the only knowledgeable source. *Id*. at *34, citing 181 F. App'x at 529.

Test of Good Faith

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

Transferee Analysis

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

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

No Dominion and Control

The Trustee further argued that the Bank's perfected security interest in about $64 million of C's deposits gave it "dominion and control." *Id*. at *21. Rejecting the Trustee's "security interest theory," the Sixth Circuit reasoned that "a security interest cannot grant dominion over $48 million more than the underlying debt." *Id*. at *22. Here, the loan agreements explicitly provided that C "owned the deposits despite

[the Bank's] security interest in them." *Id*. The law of secured transactions limits recovery upon default to the underlying debt. Id. at *22. Because C's underlying debt to the Bank was only $16 million, the Bank lacked "dominion and control over" the excess deposits. *Id*. at *23. The Bank's "rights' were limited to the amount of the [underlying] debt." *Id*. at *24. "In short, [C] retained dominion and control over its [excess] deposits despite [the Bank's] security interest in them, and [C] could use its money and other assets however it wanted to." *Id*. at *24-*25.

Thoughts on *Meoli*

Meoli confirms the fact-intensive nature of "good faith" litigation in the fraudulent transfer context. After two trials and at least five bankruptcy court opinions between 2009 and 2012 covering events occurring between 2002 and 2004, the litigation still continues. A 45-page opinion from the Sixth Circuit in this case led a concurring judge to write two more pages stressing that subsequent "transferees" such as the Bank "are not required to undertake unduly onerous investigations, and that whether an investigation is unduly onerous depends on the circumstances of the case." *Id*. at *47.

Citing other circuits, the concurring judge stressed that, under Code § 550(b)(1), "[n]o one supposes that 'knowledge of voidability' means complete understanding of the facts and receipt of a lawyer's opinion that such a transfer is voidable; some lesser knowledge will do." *Id*. at *46, quoting *Bonded Fin. Servs., Inc., v. European Am. Bank*, 838 F. 2d 890, 898 (7th Cir. 1988) (failure to make inquiry did not permit court to attribute to subsequent transferee knowledge of voidability of transaction; "'knowledge' is a stronger term than 'notice.' A transferee that lacks information necessary to support an inference of knowledge need not start investigating on his own"; bank knew nothing of debtor's "financial peril" and debtor was not bank's "customer"; debtor had provided funds to its principal who repaid the bank). *See also, In re Bressman*, 327 F. 3d 229, 236-37 (3d Cir. 2003) (law firms took in "good faith" and for "value … without knowledge of voidability"; firms paid by debtor's wife, who had received assets fraudulently).

In re Tenderloin Health

The U.S. Court of Appeals for the Ninth Circuit inexplicably ignored the Sixth Circuit's Feb. 8, 2017, "transfer" analysis in *Meoli* when it handed down a murky, if not wrong, decision on March 7, 2017. *In re Tenderloin Health*, 2017 U.S. App. LEXIS 4008, *27 (9TH Cir. Mar. 7, 2017 ("The [bank] deposit … represents the kind of pre-[bankruptcy] 'transfer' that the preference provisions target."). According to the leading bankruptcy treatise, however, "a debtor's deposit of a nonexempt check into a non-exempt bank account … is not a transfer from the debtor to [it]self … — so classifying such transactions would be akin to holding that a debtor's moving of money from one pocket to another is a transfer. The debtor's interest in the property has not substantively changed, and at all times the debtor's interest was exposed to creditors." 2 Collier, Bankruptcy ¶ 101.54, at 101-216 (16th ed. 2011), rejecting legislative history (S. Rep. No. 989, 95th Cong., 2d Sess. 27 (1978). *Accord, In re Whitley*, 848 F.3d 205, 210 (4th Cir. 2017) (" … when a debtor deposits…funds into his own unrestricted checking account in the regular course of business, he has not transferred those funds to the bank that operates the account"), citing *New York County Nat'l Bank v. Massey*, 192 U.S. 138, 147 (1904) ("…a deposit of money to one's credit in a bank does not operate to diminish the estate of the depositor…."); *Citizens Nat'l Bank v. Lineberger*, 45 F.2d 522, 527-28 (4th Cir. 1930); *In re Prescott*, 805 F.2d 719, 729 (7th Cir. 1986); *Katz v. First Nat'l Bank of Glen Head*, 568 F.2d 964, 969 (2d Cir. 1977).

Conclusion

The Sixth Circuit's *Meoli* decision is a careful, thoughtful analysis of a complex fact pattern. In addition to being a primer on fraudulent transfer law, it will help other courts and counsel better understand the meaning of "good faith" and "transfers" in this context.

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