Benchnotes

By Paul R. Hage, Aaron M. Kaufman and Patrick A. Clisham

Coordinating Editor
Paul R. Hage
Jaffe Raitt Heuer & Weiss, PC
Southfield, Mich.

Coordinating Editor
Aaron M. Kaufman
Dykema Gossett PLLC
Dallas

Coordinating Editor
Patrick A. Clisham
Engelman Berger, PC
Phoenix

Paul Hage is a partner with Jaffe Raitt Heuer & Weiss, PC in Southfield, Mich. Aaron Kaufman is a member of Dykema Gossett PLLC in Dallas. Patrick Clisham is the managing shareholder of Engelman Berger, PC in Phoenix.

Sixth Circuit Interprets Good Faith and Mere Conduit Fraudulent Transfer Defenses

In *Meoli v. The Huntington National Bank*,[1] the Sixth Circuit Court of Appeals issued an important opinion addressing two issues that often arise in fraudulent transfer cases, specifically when a bank is considered a "transferee" for purposes of § 550 of the Bankruptcy Code, and what standard should be used to assess a transferee's "good faith" for purposes of the "good faith and for value" defense set forth in § 548(c). The chapter 7 trustee sought to recover transfers made by Teleservices (the debtor) to a bank. The bank lent money to, and maintained deposits of, an affiliated company called Cyberco.

Cyberco and its principal, Barton Watson, created Teleservices to perpetuate a Ponzi scheme. Watson widely represented that Cyberco needed money to buy computer equipment, and that Cyberco purchased its equipment from Teleservices. However, Teleservices was a paper company that had no separate employees, and it acted only through Cyberco's executives, who assumed fake names for their fake Teleservices jobs. Watson borrowed money from several equipment-financing companies and instructed them to send the money directly to Teleservices to pay fake invoices for the equipment. Once they paid Teleservices, Watson moved the money from Teleservices' bank account to Cyberco's account at the bank. Watson then used that money to pay salaries and some of Cyberco's earlier debts.

The bank had loaned Cyberco more than $16 million. By September 2003, a bank employee charged with managing the Cyberco account was aware of suspicious transfers by and among the debtors. In October 2003, Watson also made a number of false representations to bank employees, which could have been contradicted had they reviewed their own files. In January 2004, the bank asked Cyberco to find a new bank.

By April 2004, a bank investigator discovered proof of past fraud by Watson. Nevertheless, such information was not widely shared internally at the bank, and the bank continued to accept substantial payments from Teleservices until it was paid in full.

The bankruptcy trustee sought to recover from the bank three types of transfers: (1) direct loan repayments, which Teleservices sent directly to the bank to pay down Cyberco's debt to the bank; (2) indirect loan repayments, which Teleservices sent to Cyberco's deposit account at the bank and Cyberco later used to repay its debt to the bank; and (3) excess deposits, which Teleservices sent to Cyberco's deposit account at the bank, and which Cyberco later withdrew or the government later seized. The bankruptcy court held that the trustee could recover all three categories of transfers from the bank, which totaled $72 million. The district court affirmed, and the bank appealed.

With respect to the excess deposits, the Sixth Circuit held that since Cyberco was free to withdraw its money from its deposit account, the bank did not have "dominion and control" over the deposits despite its security interest in them.[2] Thus, the bank was not a transferee of such funds — a requirement for recovery of a fraudulent transfer by the trustee under § 550. The bank gained "dominion and control" only over the money that it received in satisfaction of Cybcero's debt to it.

With respect to those transfers, the bank argued that it was protected by the good-faith defense set forth in § 548(c). The Sixth Circuit held that because the bank's investigator knew of Watson's fraudulent past in April 2004 and the bank continued to accept payments from Teleservices, it ceased to be protected by the good-faith defense as of that date. The standard established by the court was an objective one: "whether a reasonable person, given the available information, would have been alerted to the transfer's voidability."[3] Although the bank gained an inquiry notice of potential fraud a year earlier, the court held that mere inquiry notice did not destroy the § 548(c) defense.

Ninth Circuit Addresses § 502(b)(6) Cap on Landlord Claims

In *In re Kupfer*,[4] the Ninth Circuit Court of Appeals held that the statutory cap on a landlord's damages claim applies only to claims resulting directly from the termination of the lease and does not apply to collateral claims. Regarding claims for legal fees authorized under the lease, the court directed lower courts to bifurcate such claims based on whether such fees relate to termination or, alternatively, collateral claims such as unpaid pre-termination rent or tort claims.

The debtors leased two commercial properties pre-petition. Each lease included an arbitration clause that provided that fees and costs would be

1 *Meoli v. The Huntington National Bank*, 848 F.3d 716 (6th Cir. 2017).

2 *Id.* at 725 (citing *Bonded Fin. Servs. Inc. v. European Am. Bank*, 838 F.2d 890 (7th Cir. 1988)).
3 *Id.* at 733.
4 *Kupfer v. Salma (In re Kupfer)*, 2016 WL 7473790 (9th Cir. Dec. 29, 2016).

awarded to the prevailing party; the debtors vacated the premises pre-petition. In subsequent litigation, the arbitrators ruled in the landlord's favor and assessed damages for past and future rents totaling $1.3 million. The arbitrators also awarded attorneys' and arbitration fees of approximately $200,000.

In the debtors' bankruptcy cases, the landlords filed claims that included the fees awarded in arbitration. The debtors objected, arguing that the entire arbitral award, including the attorneys' and arbitration fees, was capped by § 502(b)(6), which provides that a landlord's claims "for damages resulting from the termination of a lease" are capped at the sum of all outstanding rent due and the greater of one year of remaining rent, or 15 percent of the remaining term (not to exceed three years). The landlords argued that the cap should apply only to unpaid past and future rent, but not to the remainder of the arbitration fee award. The bankruptcy court agreed, allowing an amount that represented the arbitration award of past and future rent as limited by the statutory cap, plus the entire uncapped claim for fees. The district court affirmed.

However, the Ninth Circuit reversed. The court began its analysis by summarizing the legislative history of § 502(b)(6), noting that the section was originally enacted to reconcile the need for landlords to be able to share in bankruptcy assets with the desire to not allow the debtor's estate to be depleted by such claims.

Turning to the issue of what damages "result from the termination of a lease," the court noted a split in the case law. On one end of the spectrum, "some courts have interpreted the provision expansively, as a kind of subject-matter cap on all lease-related damages."[5] On the other end of the spectrum, the court found that the provision has been interpreted narrowly to cap claims for future rent, but excludes all other damages, thereby permitting collateral claims to be asserted in full.

The court cited its 2007 opinion in *In re El Toro Materials Co.*, where it took the middle ground, adopting the following test: "Assuming [that] all other conditions remain constant, would the landlord have the same claim against the tenant if the tenant were to assume the lease rather than reject it?"[6] Where, as here, the lease termination occurred pre-petition, the court modified its test: "Assuming that all other conditions remain constant, would the landlord have the same claim against the tenant had the lease not been terminated?"[7]

The court held that the "all-or-nothing" approach adopted by the lower courts was incorrect, reasoning that the arbitration giving rise to the disputed fees and costs concerned claims for both unpaid pre-petition rent and future rent. Fees attributable to litigating the landlord's claims for future rent, the court held, are subject to the cap because such claims would not arise were the leases not terminated. However, fees attributable to that portion of the litigation dealing with past rent or other collateral claims, which creditors could assert independent of termination, were not capped. The court remanded the case, directing the lower courts to apportion the fees and costs incurred accordingly.

5 *Id.* at *3 (citing cases).
6 *Id.* at *4 (discussing *In re El Toro Materials Co.*, 504 F.3d 978 (9th Cir. 2007)).
7 *Id.*

Miscellaneous

• *In re RW Meridian LLC*, --- B.R. --, 2017 WL 473808 (B.A.P. 9th Cir. 2017) (BAP affirmed bankruptcy court's determination that county tax sale of real property via public auction that was initiated pre-petition but concluded post-petition was violation of automatic stay; although debtor's right to redeem property had expired pre-petition, bankruptcy court reasoned that debtor's equitable and legal interests in subject property had not divested merely upon expiration of redemption period);

• *In re W.R. Grace & Co.*, --- B.R. ---, 2016 WL 7471290 (Bankr. D. Del. 2016) (bankruptcy court found that debtor's claims bar date notice, which required claims to be filed "no matter how remote or contingent," was sufficient to bar late-filed claim by asbestos claimant that had notice of possible asbestos claim but argued that scientific determination of contamination had not been confirmed as of bar date);

• *In re WL Homes LLC*, --- B.R. ---, 2017 WL 104443 (Bankr. D. Del. 2017) (bankruptcy court ruled that insurance carrier is entitled to assert claim of recoupment for self-insured retention obligations of debtor against debtor's premium refund arising in connection with same policy; bankruptcy court rejected trustee's argument that recoupment was not appropriate because rights and obligations arose separately, which relied primarily on Second Circuit's narrower standard for recoupment as espoused in *Westinghouse Credit Corp. v. D'Urso*, 278 F.3d 138, 142 (2d Cir. 2002); bankruptcy court instead relied on Third Circuit's broader standard for recoupment articulated in *Univ. Med. Ctr. v. Sullivan (In re Univ. Med. Ctr.)*, 973 F.2d 1065, 1081 (3d Cir. 1992), which "focuses on the contractual relationship between the parties and whether the debts on both sides arise from an integrated transaction");

• *In re Santos*, 561 B.R. 825, (Bankr. C.D. Cal. 2017) (bankruptcy court denied debtors' post-discharge request to convert their chapter 7 case to chapter 13 after chapter 7 trustee moved to administer valuable real estate asset; court held that obtaining discharge and then acting to prohibit trustee from administering assets is "unfair to creditors and is a manipulation and abuse of the Bankruptcy Code"; bankruptcy court further ruled that although debtors offered to waive their discharge, debtors could not legally do so because plain language of 11 U.S.C. § 727(a)(10) requires that such waiver occur prior to granting of discharge);

• *In re Skin Sense Inc.*, --- B.R. ---, 2017 WL 474317 (Bankr. E.D.N.C. 2017) (bankruptcy court required chapter 11 debtor to segregate and hold 85 percent of post-petition gift card sales pending use of purchased cards by consumers);

• *In re Phillips*, --- B.R. ---, 2017 WL 113599 (Bankr. E.D. Tex. 2017) (bankruptcy court found that civil damages awarded for violations of privacy after debtor secretly recorded his roommate were entitled to summary judgment as nondischargeable under 11 U.S.C. § 523(a)(6); although civil judgment was entered by default, bankruptcy court held that debtor's related guilty plea as to criminal charges arising from same conduct constituted claim being actually litigated for purposes of collateral estoppel such that summary judgment was appropriate);

continued on page 78

• *Dots LLC v. Milberg Factors Inc. (In re Dots LLC)*, 562 B.R. 286 (Bankr. D.N.J. 2017) (chapter 11 debtor brought adversary proceeding to set aside pre-petition payments that it had made to factoring companies as preferential transfers; factors asserted subsequent new value defense, among others; after analyzing nature of true factoring relationships in preference context, court held that extension of new credit that debtor enjoyed as result of factoring relationship did not constitute "new value" for purposes of § 547(c)(4) because it was vendors, not factor, that extended such credit; nevertheless, factors were entitled to new value defense for value of goods that their vendors provided to debtor);

• *Gold v. Harper (In re Ambrose-Burbank)*, 2017 WL 377933 (Bankr. E.D. Mich. Jan. 25, 2017) (failure to comply with certificate of title and registration requirements under state law motor vehicle code meant that purported transferee never acquired interest in car from the debtor pre-petition; it did not matter that purported transferee took possession of vehicle, made all car payments, paid for vehicle maintenance and repairs, and bore all costs associated with insuring vehicle);

• *Hometown 2006-1 1925 Valley View LLC v. Prime Income Asset Mgmt. LLC*, 847 F.3d 302 (5th Cir. 2017) (debtor was party to services contract that contemplated monthly payments to debtor and could be terminated on 60-day notice; nevertheless, debtor and contract counterparty agreed to terminate contract immediately and for no consideration; judgment creditor of debtor commenced state law fraudulent transfer action against third party; reversing district court, Fifth Circuit held that debtor's waiver of its right to 60-day notice of termination, without compensation, constituted transfer of asset that could be avoided as fraudulent transfer);

• *In re Dumbuya*, 2017 WL 486917 (Bankr. N.D. Ohio Feb. 6, 2017) (noting split in case law, court held that 90-day deadline for filing claims in chapter 13 case set forth in Bankruptcy Rule 3002(c) applies to both secured and unsecured creditors, even though secured creditors are not required to file claims in chapter 13 case);

• *In re Hutsler*, 2016 WL 7984348 (Bankr. W.D. Mo. Dec. 19, 2016) (creditor objected to debtors' chapter 13 plan on grounds that plan modified its secured claim in violation of § 1322(b)(2)'s anti-modification provision regarding residential mortgages; land consisted of three parcels of real property; one parcel contained debtors' principal residence, whereas other two consisted of home on which debtor's father resided and land that he farmed; focusing on status of property at time of mortgage transaction, court found that anti-modification provision was applicable because parties at that time considered loan, and property, to be residential, not commercial, in nature);

• *In re Robinson*, 2017 WL 713571 (Bankr. N.D. Ga. Feb. 22, 2017) (issue before court was what a reference to "interest at the legal rate" means under § 726(a)(5) for purposes of distribution on unsecured claims in chapter 7 case where estate has sufficient assets to pay post-petition interest; while acknowledging that some courts have applied contractual rate of interest, court interpreted statutory language as requiring application of federal judgment rate);

• *Khan v. Barton (In re Khan)*, 846 F.3d 1058 (9th Cir. 2017) (Ninth Circuit held that creditor's claims were not subject to mandatory subordination under § 510(b) because creditor's claims did not "arise out of a purchase or sale of a security of the debtor"; rather, claims were based on state court judgment entered against debtors pre-petition on account of their actions in fraudulently converting creditor's stock);

• *Loventhal v. Edelson*, 844 F.3d 662 (7th Cir. 2016) (transfer of home owned by husband and wife as tenants by entirety to husband's living trust, which designated both husband and wife as beneficiaries, did not sever entireties protection; as such, home was exempt pursuant to § 522(b)(3)(B) in wife's subsequent chapter 13 filing);

• *Lynch v. Jackson*, 845 F.3d 247 (4th Cir. 2017) (Fourth Circuit held, on direct appeal, that means test set forth in § 707(b)(2) permits debtor to use full IRS National and Local Standard amounts for expenses, even though debtors' actual expenses were significantly less than such standard amounts; "A debtor is entitled to take the full amount ... if they incur an expense in that category"; accordingly, bankruptcy court did not err in concluding that presumption of abuse was not applicable with respect to bankruptcy administrator's motion to dismiss case); and

• *Veltre v. Fifth Third Bank (In re Veltre)*, 562 B.R. 890 (Bankr. W.D. Pa. 2017) (junior mortgage-holder acquired debtor's property through foreclosure sale conducted pursuant to applicable state law pre-petition, which allowed it to receive payment in full and acquire debtor's equity in property; noting split in case law, court held that "a valid, legal, and noncollusive sheriff's sale cannot be undone or otherwise avoided by a preferential transfer action" under § 547, even where all of statutory elements of preference are present). abi