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Mind Your Netting: The Fifth Circuit Clarifies the Section 548(c) Good Faith Fraudulent Transfer Defense

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Section 548(a) of the United States Bankruptcy Code (the "Code") empowers a bankruptcy trustee to recover an actual or constructively fraudulent transfer made within the two-year period prior to the debtor's bankruptcy filing. Even when a fraudulent transfer has been made, however, an innocent transferee is protected from liability by section 548(c) of the Code if the transferee acted in good faith and to the extent the transferee provided value to the debtor. In a recent case, the Fifth Circuit examined the meaning of "value" in section 548(c) of the Code and clarified what should happen if the transferee gives less value than the debtor receives.

In *Williams v. Federal Deposit Insurance Corp. (In re Positive Health Management)*, 769 F.3d 899 (5th Cir. 2014), Positive Health Management, Inc. (the "Debtor") was owned by Ronald Ziegler. In 2005, First National Bank ("First National")[1] made a loan to a second corporate entity owned by Ziegler that was secured by a building that the Debtor used for office space. Though the Debtor had no direct obligations under the loan, it made a series of payments to First National totaling $367,681.35 that it listed as rent on its tax returns. The Debtor ultimately stopped paying the loan and First National foreclosed on the office building. After the Debtor filed for bankruptcy, the Chapter 7 trustee brought an adversary proceeding to recover the payments as fraudulent transfers under section 548 of the Code.

The Bankruptcy Court determined that the Debtor received reasonably equivalent value for the transfers to First National on two alternative grounds. First, First National's forbearance from foreclosing on the office property allowed the Debtor to continue running its operations and generate over $4 million of cash flow. Second, the court found that the rent payments enabled the Debtor to continue using the office space and constituted “reasonably equivalent value” as described in section 548(a)(1)(B) of the Code. Relying on its conclusion that the Debtor received reasonably equivalent value, the court determined that First National was able to establish a good faith fraudulent transfer defense under section 548(c), and was therefore entitled to keep the funds that it received. The trustee appealed this ruling.

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"Value" for Purposes of Section 548(c) Is Analyzed from the Transferee's Perspective, Not the Transferor's

A transferee provides value when it receives the allegedly voidable transfer in exchange for "property, or satisfaction or securing a present or antecedent debt of the debtor..." 11 U.S.C. § 548(d)(2)(A). The trustee did not contest that First National acted in good faith, but did contest that it provided value. The Fifth Circuit began its analysis by discussing its prior holding that "value" for purposes of section 548(c) must be assessed from the perspective of what the transferee gave up rather than what the debtor received. Jimmy Swaggart Ministries v. Hayes (In re Hannover Corp.), 310 F.3d 796, 799–802 (5th Cir. 2002). The court found that the Bankruptcy Court's first value determination—that First National's forbearance allowed the Debtor to generate $4 million of cash flow—considered value from the Debtor's perspective instead of First National's in contravention of Hannover. The Bankruptcy Court did correctly value the benefit to the Debtor for the use of the office space when it concluded that the value to the Debtor was equal to market rent, or $253,333.33. Because First National provided value and acted in good faith, the court determined that it was entitled to assert the section 548(c) defense.

Valuation Under Section 548(a) Versus Section 548(c) of the Code

The Bankruptcy Court cited *Hannover* as a basis for equating the "reasonably equivalent value" that must be lacking for a transfer to be avoidable under section 548(a)(1) of the Code with the "value" necessary to assert the section 548(c) defense. The Fifth Circuit noted that, though other bankruptcy courts have also cited Hannover for this preposition, the reading is mistaken. Relying on Collier's, the court determined that "value" in section 548(c) was not the same as "reasonably equivalent value" in section 548(a)(1)(B), and to equate the two would read the "to the extent" language out of the statute. As a result, the Code allows a good faith purchaser to assert a lien for any amount provided, even though the value provided was less than the value of the property it received.

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Netting Is Required If the Transferee Gives Less Than the Debtor Receives

Although First National was entitled to assert the defense, the trustee argued that the language of section 548(c) requires that the court reduce the value of the fraudulent transfers ($367,681.35) by the value of the appraised market rent ($253,333.33) and award the difference to the bankruptcy estate. The trustee based this argument on the plain language of the section, which reads that a transferee who has provided value in good faith "may retain any interest transferred... to the extent that such transferee... gave value to the debtor in exchange for such transfer or obligation." 11 U.S.C. § 548(c) (emphasis added). Though the Bankruptcy Court found that First National was entitled to keep the entirety of the transfers because the rental value was "reasonably equivalent" to the amount of the transfer, the Fifth Circuit held that a netting approach was proper based upon the text of the Code. Therefore, the trustee was entitled to recover the $114,348.02 difference between the fraudulent payments that First National received and the value that it gave in return.

This case clarifies that any good faith transferee that gives any value to a debtor is entitled to the protections of section 548(c) of the Code, but only to the extent of the actual value given. Lenders should be mindful that even if they act in good faith and provide value to the debtor, the Fifth Circuit has read the text of section 548(c) to require that the court apply a netting approach if the transferee received more value than the consideration it gave up in return. The trustee may then claw back any fraudulent payments that exceed the value given by the transferee to the debtor into the bankruptcy estate.

If you have any questions about good faith fraudulent transfers under the Code, please contact your Reinhart attorney or any member of Reinhart's Business Reorganization group.

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[1] After the complaint was filed but prior to the Circuit Court’s decision, First National was taken over by the FDIC.

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