# Targeting the Trustee-Transferee: Fraudulent Conveyance Liability Recently Extended to Trustees of Special Purpose Vehicles

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The United States Bankruptcy Code contains several provisions that enable representatives of a bankruptcy estate to avoid loan obligations, security interests, and cash payments as fraudulent conveyances. To the extent such avoidance actions are successful, the Bankruptcy Code also specifies from whom the fraudulently transferred property can be recovered. The United States Court of Appeals for the Seventh Circuit recently addressed the question of whether the trustee for a pool of securitized assets – commonly referred to as a "special purpose vehicle" ("SPV") – is an entity from whom fraudulently transferred property can be recovered by the bankruptcy estate. This article provides a brief overview of the substantive aspects and procedural implications of that decision.

## The Statutory Framework

Section 548(a) of the Bankruptcy Code provides, among other things, that a transfer of property which occurred within two years before the bankruptcy filing can be avoided for the benefit of the estate if the estate representative is able to establish that the debtor *either:* (1) made the transfer with "actual intent to hinder, delay, or defraud" a creditor; *or* (2) both– (a) received "less than a reasonably equivalent value" in exchange for the property transferred, and (b) was financially impaired at the time or as a result of the transfer.[1]

After a transfer of property successfully has been avoided, section 550(a) of the Bankruptcy Code permits the estate representative to recover the property transferred or the value thereof from either the "initial transferee," an "immediate or mediate transferee" of the initial transferee, or "an entity for whose benefit such transfer was made."[2]

Although the Bankruptcy Code does not define any of these terms, the United States Court of Appeal for the Seventh Circuit – in *Bonded Financial Services v. European American Bank*, a twenty year-old decision that has been widely adopted by courts at all levels across the nation – held that a financial intermediary which does not exercise dominion or control over fraudulently transferred assets is not an "initial transferee" for purposes of section 550(a).[3]

In August 2010, however, the same court held that a trustee of a SPV is an "initial transferee" for purposes of section 550 of the Bankruptcy Code.

## Palonian V. Lasalle Bank, N.A.

In *Paloian v. LaSalle Bank N.A.*,[4] a bank extended a pre-petition credit facility to the debtor through the company (the "Landowner") that owned the debtors' building and land. As part of this transaction, the debtor agreed to pay the Landowner additional rent and the Landowner gave the bank a security interest in the incremental rent. The bank subsequently sold the loan to a third-party that pooled several billion dollars of commercial credit into a SPV for resale to investors. The SPV's assets comprised borrowers' notes and the security interests that collateralized the notes, while the SPV's investors held commercial mortgage pass-through certificates. The SPV's trustee soon began receiving the incremental rent payments directly from the debtor.

After the debtor filed for bankruptcy, the bankruptcy trustee commenced an adversary proceeding against the SPV's trustee (the "Investor Trustee") alleging, among other things, that the incremental rent payments made by the debtor were fraudulent transfers. The bankruptcy court concluded that the payments constituted fraudulent transfers and ordered the Investor Trustee to return the payments pursuant to section 550(a) of the Bankruptcy Code. On appeal, however, the Investor Trustee – relying upon *Bonded Financial Services* – argued that it simply was the agent for placing the funds into the SPV for the benefit of its investors, was not an "initial transferee" of the fraudulently transferred funds, and thus was an inappropriate target of a turnover order.

The Court of Appeals rejected the Investor Trustee's argument and refused it shelter under what has become known as the "mere conduit" exception to section 550(a). In so doing, the Court held – as a matter of apparent first impression for the federal appellate courts – that the Investor Trustee was the "real recipient," and thus the "initial transferee," of the transfers to the SPV:

> *Bonded Financial Services* adopted an approach that tracks the function of the bankruptcy trustee's avoiding powers: to recoup money from the real recipient of [avoided] transfers. In *Bonded Financial Services*, that recipient was the bank's customer, who had full control over the balance in the checking account [upon which the customer drew a check for the fraudulently transferred funds]. In this situation, the real recipient is [the Investor Trustee], which is the trustee of the securities pool. In American law, a trustee is the legal owner of the trust's assets. . . . Although [the Investor Trustee]

1 *11 U.S.C. § 548(a)(1)–(2).*
2 *Id. § 550(a).*
3 *See 838 F.2d 890 (7th Cir. 1988).*
4 *2010 WL 3363596 (7th Cir. Aug. 27, 2010) (Easterbrook, C.J.).*

has duties to the trust's beneficiaries (the investors) concerning the application of funds, the assets' owner remains the appropriate subject of a[n] avoidance action. . . . We cannot find any appellate decision on the question of whether a trustee for a securitized investment pool is an "initial transferee" under § 550(a). But lots of decisions hold that an entity that receives funds for use in paying down a loan, or passing money to investors in a pool, is an "initial transferee" even though the recipient is obliged by contract to apply the funds according to a formula. All of these courts say that they are adopting and applying the approach that this circuit devised in *Bonded Financial Services*. We agree with that assessment and shall not create a conflict among the circuits on the question how to interpret one of our own opinions.[5]

The implication of this conclusion is significant. To the extent that a SPV's trustee is deemed the "initial transferee" of the SPV's assets, that trustee cannot avail itself of the good-faith defense afforded by section 550(b) – a defense to recovery that only is available to a good-faith transferee other than the "initial transferee" or an "entity for whose benefit [the fraudulent] transfer was made."[6] And because the court also recognized that SPV's investors are "the persons for whose benefit" the SPV's assets are transferred, those investors would similarly be unable to avail themselves of the section 550(b) good-faith defense.

## The Procedural Implications of *Palonian*

Generally, any transferee who is in possession of fraudulently transferred property is a necessary party to an avoidance action because disposing of the action in the possessor's absence might, as a practical matter, impair or impede its ability to protect its interest in the property.[7] There is a conflict of authority, however, as to the necessity of making a transferee who is not in possession a party defendant to the action.[8] As a result, estate representatives who prosecute avoidance actions against investment vehicles often are confounded by the same procedural question: Are the investors necessary defendants in such actions? In dicta, the *Paloian* court said "no":

> Instead of requiring the bankruptcy trustee to sue thousands of investors who may have received interest payments that were increased, slightly, by money from the [debtor's] coffers, a single suit suffices. If the [debtor] had made a[n avoidable] transfer to Exxon, it would be appropriate to recover that transfer from Exxon rather than the millions of people who hold stock in Exxon. Similarly with a[n avoidable] transfer to a hedge fund. Instead of suing each investor, the bankruptcy estate could recover from the fund. Likewise, a[n avoidable] transfer to a trust is appropriately recovered from the trustee, who will charge it to the trust and thus create the appropriate economic incidence.[9]

Generally, a person who is not made a party to litigation is "not bound by a judgment in personam resulting from litigation in which he is not designated as a party or to which he has not been made a party by service of process."[10] However, this rule (often called the "rule of prior adjudication") is subject to certain exceptions, one of which is the common -law principle that a judgment can also bind a person not made party to the litigation in question if the non-party is in "privity" with one of the litigants.[11] Section 41 of the RESTATEMENT (SECOND) OF JUDGMENTS articulates this exception to the general rule:

> (1) A person who is not a party to an action but who is represented by a party is bound by and entitled to the benefits of a judgment as though he were a party. A person is represented by a party who is: . . .
>
> (c) The executor, administrator, guardian, conservator, or similar fiduciary manager of an interest of which the person is a beneficiary . . . .
>
> (2) A person represented by a party to an action is bound by the judgment even though the person himself does not have notice of the action, is not served with process, or is not subject to service of process. . . .[12]

Federal courts have consistently recognized this common-law exception to the general rule of prior adjudication.[13] For example, in *Kersh Lake Drainage Dist. v. Johnson*, the United States Supreme Court expressly stated that the common-law exception to the rule of prior adjudication encompasses the relationship between bondholders and their trustee:

> It has been held that bondholders are not necessary parties to and are bound by the decree – even if adverse to their interests – in litigation wherein an indenture trustee under a bond issue is a party and exercises in good faith and without neglect his contractual authority to represent and assert the lien securing the issue.[14]

The *Paloian* decision extends the common-law exception to the rule of prior adjudication to the fraudulent conveyance arena, and specifically to section 550(a) of the Bankruptcy Code.

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5 *Paloian, 2010 WL 3363596, at *3.*

6 *11 U.S.C. § 550(b).*

7 *See, e.g., Cendant Corp. v. Shelton, 473 F.Supp.2d 307 (D. Conn. 2007); FED. R. CIV. P. 19(a)(1).*

8 *See W.J. Dunn, Annotation, Necessary Parties Defendant to Action to Set Aside Conveyance in Fraud of Creditors, 24 A.L.R.2d 395 (1952).*

9 *Paloian, 2010 WL 3363596, at *3.*

10 *Zenith Radio Corp. v. Hazeltine Research, Inc., 395 U.S. 100, 110 (1969).*

11 *Meza v. Gen. Battery Corp., 908 F.2d 1262, 1266 (5th Cir. 1990); U.S. v. Truckee-Carson Irrigation Dist., 649 F.2d 1286, 1303 (9th Cir. 1981).*

12 *RESTATEMENT (SECOND) OF JUDGMENTS § 41 (1982) (emphasis supplied).*

13 *See, e.g., Kerrison v. Stewart, 93 U.S. 155, 160 (1876); Kersh Lake Drainage Dist. v. Johnson, 309 U.S. 485, 491 (1940); U.S. Steel Corp. Plan v. Musisko, 885 F.2d 1170, 1179 (3d Cir. 1989); Pelfresne v. Village of Williams Bay, 865 F.2d 877, 881 & n.3 (7th Cir. 1989).*

14 *Kersh Lake Drainage Dist., 309 U.S. at 491.*