Subsequent Transferee’s Good Faith for Value Defense: The Second and Ninth Circuit’s Perspective

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Subsequent Transferee’s Good Faith for Value Defense: The Second and Ninth Circuit’s Perspective

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Introduction

Under section 548(a)(1) of title 11 of the United States Code (the “Bankruptcy Code”), a trustee may “avoid any transfer . . . incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition” if there is either an “actual intent” fraudulent transfer or a “constructive” fraudulent transfer. The trustee, however, may not recover if a subsequent transferee can satisfy the good faith for value defense and demonstrate that it “took for value . . . in good faith, and without knowledge of the voidability of the transfer avoided” or “any immediate or mediate good faith transferee” under section 550(b).

This memorandum analyzes the good faith for value defense exclusively in “actual intent” fraudulent transfer cases within the Second and Ninth Circuits. Part I of this memorandum analyzes the Bankruptcy Code’s subsequent transferee’s good faith for value defense. Part II examines the interpretation of the good faith for value defense under section 550(b)(1) in the Second Circuit, which includes New York. Part III examines the interpretation

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of the good faith for value defense under section 550(b)(1) in the Ninth Circuit, which includes California. Part IV explores the distinction between the Second and Ninth Circuits’ interpretation and application of the good faith for value defense under section 550(b)(1).

Discussion

I. The Bankruptcy Code’s Subsequent Transferee’s Good Faith for Value Defense

Section 550(b) of the Bankruptcy Code provides the affirmative “good faith for value” defense, which is only applicable to subsequent transferees to assert when a trustee is attempting to recover an avoidable transfer from the “initial transferee of such transfer or the entity for whose benefit such transfer was made” under section 548. A subsequent transferee satisfies the good faith for value defense against a trustee claiming “actual intent” fraudulent transfer when three elements are met. The good faith for value defense may be applied when the subsequent transferee demonstrates the transfer was: (1) in good faith, (2) accepted for value, and (3) without the knowledge of the transfer’s voidability. However, if a subsequent transferee fails to satisfy the good faith for value defense, a trustee may recover against the transferee.

The Bankruptcy Code does not provide definitions for each element of the good faith for value defense, and the Second and Ninth Circuits interpret the standards differently. Consequently, this has established differing standards the subsequent transferee must meet based on which circuit the case was filed. The Second and Ninth Circuits have interpreted the

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4 Id.
5 11 U.S.C. §550(b)(1); In re Enron Corp., 333 B.R. 205, 234 (Bankr. S.D.N.Y. 2005); Abele v. Mod. Fin. Plans Servs., Inc. (In re Cohen), 300 F.3d 1097, 1102 (9th Cir. 2002).
7 Id.
8 Compare Banner v. Kassow, 104 F.3d 352 (2d Cir. 1996) (applying subjective good faith standard considering circumstances surrounding transferee’s actions) with Hayes v. Palm Seedlings Partners-A (In re Agric. Rsch. & Tech. Grp, Inc.), 916 F.2d 528 (9th Cir. 1990) (applying objective good faith standard whether transferee knew or should have known of voidability).
elements of “good faith” and “knowledge” differently, leaving courts in each circuit to interpret their meanings under section 550(b)(1) as what it deems “more correct.”

II. Second Circuit’s Analysis and Application of Good Faith for Value Defense Standard

A. Good Faith Standard

The United States Court of Appeals for the Second Circuit has concluded that good faith is not satisfied when the subsequent transferee has “‘sufficient knowledge [of the circumstances surrounding the transfer] to place him on inquiry notice of the debtor’s possible insolvency.’” According to the Second Circuit, good faith is lacking when a subsequent transferee chooses to intentionally ignore “red flags,” which suggests fraudulent activity.

In *In re Goldberg*, a Connecticut bankruptcy court employed the good faith standard set forth by the Second Circuit *In re Bernard L. Madoff* and found that the transferee had not satisfied this standard. The *Goldberg* Court analyzed whether the transferee had sufficient knowledge of the circumstances surrounding the transfer. In this case, the Goldbergs (the “Debtors”) operated a Ponzi scheme for twelve years, during which the transferee (the “Transferee”), an experienced real estate developer, invested $300,000.00 into the Debtors’ scheme. Prior to investing, the Transferee spoke with his son, Scott LaBonte, who had suggested the transfer to the Debtors’ scheme and had learned the Debtors were using investor funds to purchase and resell foreclosed properties while providing twenty percent profit back to its investors. However, the Transferee failed to conduct any due diligence whatsoever despite

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10 *Banner*, 104 F.3d at 352.
13 *Id.*
14 *Id.* at 233.
15 *Id.* at 238.
his extensive background and knowledge in real estate development.\textsuperscript{16} Upon the Debtors filing for bankruptcy, the Transferee sought to assert a good faith for value defense against the trustee.\textsuperscript{17} The Connecticut bankruptcy court, however, found that because the Transferee knew about the Debtors’ scheme, the transferee was on sufficient notice of the Debtors’ possible fraudulent nature.\textsuperscript{18} Further, the Transferee was aware of other individuals’ concerns about the Debtors’ business and ignored the numerous red flags.\textsuperscript{19} Because the Transferee failed to inquire about the business and did not investigate any documents, the bankruptcy court concluded that the Transferee did not act in good faith.\textsuperscript{20}

\textbf{B. Standard for Whether the Transfer was Accepted “For Value”}

The Second Circuit’s interpretation of the term “for value,” looks to what the transferee gave up as opposed to what the debtor received.\textsuperscript{21} Bankruptcy courts in the Second Circuit have held that “value” need not be a reasonably equivalent value but is met by consideration sufficient to support a simple contract.\textsuperscript{22}

Using this standard, in \textit{In re Colmark I Ltd. P’ship}, the Connecticut bankruptcy court found that the defendant’s acceptance of a $250,000 check for legal services to assist plaintiff with a possible bankruptcy filing was sufficient to satisfy the “for value” element.\textsuperscript{23} Moreover, the court concluded that because the defendant provided services to the plaintiff, “value to the transfer is sufficient.”\textsuperscript{24} Similarly, in \textit{In re Bernard L. Madoff}, the Southern District of New York, implementing the Second Circuit’s interpretation that “for value” is satisfied by monetary

\begin{footnotesize}
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  \item \textsuperscript{16} \textit{Id.} at 234.
  \item \textsuperscript{17} \textit{Id.}
  \item \textsuperscript{18} \textit{Id.} at 238.
  \item \textsuperscript{19} \textit{Id.}
  \item \textsuperscript{20} \textit{Id.} at 239.
  \item \textsuperscript{22} \textit{In re Bernard L. Madoff}, 608 B.R. 181, 195 (Bankr. S.D.N.Y. 2019).
  \item \textsuperscript{23} 189 B.R. at 257.
  \item \textsuperscript{24} \textit{Id.}
\end{itemize}
\end{footnotesize}
consideration, found that value was satisfied when defendants loaned $300 million for an investment, which the transferee repaid through loans to the subsequent transferee. These independent monthly loan payments satisfied the “for value” standard despite being significantly less than the initial $300 million payment.

C. Standard for Without “Knowledge” of the Voidability of the Transfer

In the Second Circuit, courts consider the “good faith” and “knowledge” elements of the good faith for value defense simultaneously. To satisfy the knowledge of the voidability of the transfer element, a court does not require the transferee to have complete understanding of the facts to constitute knowledge. Rather, if a transferee has lesser knowledge of the voidability of the transfer, but has knowledge nonetheless, the transferee will be found to have had knowledge. Additionally, because the Bankruptcy Code does not define “knowledge,” there is further ambiguity regarding the level of knowledge necessary to satisfy this element. The United States District Court for Southern District of New York, in In re Thakur, considered the Second Circuit’s holding in Banner v. Kassow, stating that “if a transferee possesses knowledge of facts that suggest a transfer may be fraudulent,’ he has sufficient knowledge to preclude his incantation of §550(b)’s defense.”

The Thakur Court found that because the transferee was aware that the debtor had transferred the property only seven weeks before the scheduled closing to a corporate entity, which suggested fraud, the subsequent transferee had some knowledge of the voidability. The

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25 608 B.R. at 195.
26 Id.
28 Id.
29 Id.
30 Id.
31 Id. (quoting Banner, 104 F.3d at 352).
32 Id. at 421.
court further concluded that the transferee’s knowledge that the debtor had financial difficulties which was corroborated by their email correspondence, further supported a finding that the transferee failed to satisfy the good faith for value defense.  

III. Ninth Circuit’s Analysis and Application of Good Faith for Value Defense Standard

A. Good Faith Standard

Distinguishable from the Second Circuit’s interpretation of the good faith for value defense, the United States Court of Appeals for the Ninth Circuit adopted an objective standard of how to determine whether a subsequent transferee was acting in good faith.  

The Ninth Circuit analyzed what the “transferee objectively ‘knew or should have known’ in questions of good faith, rather than examining what the transferee actually knew from a subjective standpoint.” Similarly, the Nevada bankruptcy court, which sits in the Ninth Circuit, applied this same objective standard finding that if a subsequent transferee has knowledge of the transferor’s or debtor’s insolvency, particularly where the transferee neglected to further inquire with reasonable diligence, the transferee may be unable to claim he acted in good faith.  

The Ninth Circuit in Hayes, applying this objective standard of “good faith,” found that the transferee did not act in good faith when he received a transfer in high excess of the value he exchanged for it and also stated that the transfers would induce new investment. The Ninth Circuit declared that the subsequent transferee should have known that the transfer was fraudulent, set off by the exchange of grossly disproportionate transfers.  

\begin{itemize}
  \item \textit{Id.}
  \item Hayes v. Palm Seedlings Partners-A \textit{(In re Agric. Rsch. & Tech. Grp, Inc.)}, 916 F.2d 528 (9th Cir. 1990).
  \item \textit{Id.}
  \item Hayes, 916 F.2d at 539.
  \item \textit{Id.}
\end{itemize}
added that the facts strongly suggest that the transferee not only knew of the fraud, but likely participated in it, and thus could not prevail under a good faith for value defense.\textsuperscript{39}

B. Standard for Whether the Transfer was Accepted for Value

Courts in the Ninth Circuit have agreed that the “for value” element need not be the precise value exchanged. Specifically, courts in the Ninth Circuit have interpreted value to mean reasonably equivalent value, rejecting the Eighth Circuit’s suggestion that value is satisfied only with an amount equivalent to the fair market value.\textsuperscript{40} According to a California bankruptcy court, reasonably equivalent value “balances the interests of the creditors against those of innocent third parties, provides receipt of something more than that which is sufficient to support a contract … and leaves the court with some latitude to apply a flexible . . . standard.”\textsuperscript{41} In 2014, a California bankruptcy court reconsidered the “for value” standard, noting Laguna Beach’s finding, and concluded that it need not rule on the standard.\textsuperscript{42} The BR Festivals Court did note, however, that the more correct standard for value “is merely consideration sufficient to support a simple contract.”\textsuperscript{43}

The California bankruptcy court in Laguna Beach analyzed that because the defendant received $200,000 for the right to purchase the option, but failed to transfer anything in return, the reasonably equivalent standard of “for value” was not satisfied.\textsuperscript{44} This was further evidenced by the transferee neglecting to fulfill his further obligations once the payment was received.\textsuperscript{45}

\textsuperscript{39} Id.
\textsuperscript{40} In re Laguna Beach Motors, Inc., 159 B.R. 562, 568 (Bankr. C.D. Cal. 1993).
\textsuperscript{41} Id.
\textsuperscript{43} Id.
\textsuperscript{44} In re Laguna Beach Motors, Inc., 159 B.R. at 568.
\textsuperscript{45} Id. at 569.
C. Standard for Without “Knowledge” of the Voidability of the Transfer

The Ninth Circuit’s standard for the “knowledge” of voidability of the transfer element does not require that the subsequent transferee have actual knowledge of the voidability of the transfer.\(^{46}\) Rather, the Ninth Circuit requires a finding that the transferee “ha[s] knowledge of sufficient facts that: (1) puts the transferee on notice that the transfer might be avoidable, or (2) requires further inquiry into the situation and such inquiry is likely to lead to the conclusion that the transfer might be avoidable.”\(^{47}\)

The California bankruptcy court, in In re Richmond Produce Co., Inc., found that the transferee, in asserting a good faith for value defense, failed to prove it acted without knowledge of the voidability of the transfer because it had some knowledge of the sale and intended to use those details to leverage its own purchase of stock.\(^{48}\) Further, the transferee’s defense failed because it was on notice that the transaction may have been fraudulent due to the debtor’s financial issues and the leveraging of the buyout stock.\(^{49}\) Thus, even if the transferee did not have actual knowledge of the voidability of the transfer, it should have conducted further inquiry.\(^{50}\) Not doing so is equivalent to turning a blind eye and is insufficient to satisfy the good faith for value defense under section 550(b)(1).\(^{51}\)

IV. Distinctions in Application of Good Faith for Value Defense

The Second and Ninth Circuit apply different standards of “good faith” in the good faith for value defense. The Ninth Circuit applies a strict objective standard whereas the Second Circuit allows for circumstances surrounding the transfer to contribute to whether the transferee

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\(^{46}\) In re Richmond Produce Co., Inc., 195 B.R. 455, 464 (N.D. Cal. 1996).
\(^{47}\) In re Goodwin, 115 B.R. 674, 677 (Bankr. C.D. Cal. 1990).
\(^{48}\) 195 B.R. at 460–61.
\(^{49}\) Id. at 464.
\(^{50}\) Id.
\(^{51}\) Id.
acted in good faith.\textsuperscript{52} Considering the circumstances surrounding the transfer, Second Circuit courts have considered whether “red flags” have been ignored by the transferee resulting in willful blindness akin to bad faith.\textsuperscript{53}

The Second Circuit, like the majority of circuits, claim subsequent transferees can satisfy “for value” with consideration sufficient to support a simple contract.\textsuperscript{54} The Ninth Circuit’s application of “for value” considers a “reasonably equivalent” standard.\textsuperscript{55} However, a court in the Ninth Circuit has stated, but has not adopted, that the simple contract for value is the more appropriate standard.\textsuperscript{56} Lastly, both Second and Ninth Circuit courts agree that knowledge is met if the transferee has knowledge suggesting fraud.\textsuperscript{57} Specifically, the Ninth Circuit does not require proof of actual knowledge. Similarly, the Second Circuit determined sufficient knowledge does not require the transferee to have a complete understanding of the facts.\textsuperscript{58}

Conclusion

The Second Circuit and Ninth Circuit approaches to the good faith for value defense have different standards for satisfying the element of “good faith.” Because determining if one acts in good faith requires a fact intensive analysis, courts employ the approaches already developed within their respective circuit.\textsuperscript{59} Thus, depending on whether a subsequent transferee asserts its

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\item \textsuperscript{52} \textit{Compare} Hayes v. Palm Seedlings Partners-A (\textit{In re} Agric. Rsch. & Tech. Grp, Inc.), 916 F.2d 528 (9th Cir. 1990) \textit{with} Banner v. Kassow, 104 F.3d 352 (2d Cir. 1996).
\item \textsuperscript{53} \textit{In re} Bernard L. Madoff, 608 B.R. 181, 196 (Bankr. S.D.N.Y. 2019).
\item \textsuperscript{54} \textit{Id.} at 195.
\item \textsuperscript{55} \textit{See In re} Laguna Beach Motors, Inc., 159 B.R. 562, 568 (Bankr. C.D. Cal. 1993).
\item \textsuperscript{56} \textit{See In re} BR Festivals, LLC, No. 14-10175, 2014 WL 6846249, at *3 (Bankr. N.D. Cal. Dec. 1, 2014).
\item \textsuperscript{57} \textit{See In re} Thakur, 498 B.R. 410, 420 (S.D.N.Y. 2013); \textit{In re} Richmond Produce Co., Inc., 195 B.R. 455, 464 (N.D. Cal. 1996).
\item \textsuperscript{58} \textit{Id.}
\end{itemize}
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good faith for value defense in the Second or Ninth Circuit, different standards of proof for “good faith” will be required.60

60 In re Sherman, 67 F.3d 1348, 1355 (8th Cir. 1995).