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Healthcare Bankruptcy: Not Garden-Variety

By David A. Samole

Various factors, including increased competition and reimbursement landscape challenges, have led hospitals, health systems, physician groups, assisted-living facilities and other providers to file for bankruptcy over the last few years. For the remainder of 2017, due in part to the current uncertainty in the healthcare industry and its legislative oversight, more financially distressed providers are considering Chapter 11 bankruptcy to effectuate closures, consolidation, restructurings and related transactions.

Expanding the Role Call in Healthcare Provider Chapter 11

The Patient-Care Ombudsman

Healthcare provider bankruptcies differ from garden-variety Chapter 11 cases. While providers deal with the usual staple of lenders, vendors and employees in Chapter 11, they also address patients' care, record-keeping and privacy rights, at times with intermediary oversight by a court-appointed patient-care ombudsman. The Bankruptcy Code requires the appointment of a patient-care ombudsman within 30 days after commencement of a "health care business" bankruptcy case, unless the court finds that an ombudsman is not necessary for the protection of the patients under the facts and circumstances of the case.

An ombudsman is required to monitor the quality of patient care, represent the interests of the patients during the bankruptcy case, and protect confidential patient records. If it is determined that the provider will need to shutter its operations for financial or regulatory reasons, or issues arise with insufficient quality of patient care, the provider could be required to transfer its patients to another facility providing substantially similar care within the vicinity, and adhere to related patient notice requirements.

The ombudsman must report to the bankruptcy court and parties-in-interest every 60 days regarding the quality of patient care. If the ombudsman determines that the quality of patient care is declining or otherwise is being

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

Part Two of a Two-Part Article

By Michael L. Cook

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

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materially compromised, he or she must detail that determination in a written report that must be filed with the court. The fees of the ombudsman, which may include the fees of any professionals retained by the ombudsman, are paid by the bankruptcy estate and are entitled to administrative expense priority. The anticipated expense of a patient care ombudsman is something that would need to be included in a cash collateral budget with the applicable secured lender.

Government and Private Insurance Company Payers

Not every healthcare provider Chapter 11 will require the appointment and participation of a patient-care ombudsman, but every provider Chapter 11 will involve participation by payers including the government and/or private insurance companies. The provider versus payer terrain is difficult enough outside of bankruptcy, where federal and state governments have roles as payers and/or regulators, and both government and private insurance company payers simultaneously can be debtors and creditors of a healthcare provider relative to issues of underpayments, zero payments and overpayments. However, in a healthcare provider bankruptcy, these issues are complicated by disputed bankruptcy court jurisdiction over the provider reimbursements and payer claims reconciliation process relative to exhaustion of administrative remedies, the automatic stay, and setoff and recoupment rights, as well as disputing the treatment of provider agreement obligations in free and clear sales and/or assignments of executory contracts under Sections 363(f) and 365 of the Bankruptcy Code.

Many times, these matters affect a provider's ability to successfully reorganize or maximize the value of its assets in a bankruptcy sale, which otherwise would enable the provider or its purchaser to maintain operations, preserve the level of healthcare for patients and address its other constituents.

Pledging Government Receivables As Collateral

Often, receivables owed from a payer are pledged as collateral to a provider's lender, which again raises issues in the government payer context. Exercising remedies on government accounts receivable is complicated because the receivables are subject to related federal and state "Anti-Assignment Rules" affecting Medicare and Medicaid healthcare programs.

These Anti-Assignment Rules require that Medicare and Medicaid payments be made only to a deposit account over which the healthcare provider has sole control. Any attempt by a provider to assign these receivables in violation of the Anti-Assignment Rules may result in the termination of the provider agreement. However, parties have enacted a successful work-around mechanism in which the government receivables and their proceeds are deposited directly into a provider's bank account, and then the government payments are subsequently swept daily into a second deposit account under the lender's control.

Upon a provider bankruptcy filing, however, a lender must stop the automatic sweep of cash from the provider's account due to the Bankruptcy Code's automatic stay. Further, a lender's floating lien on after-acquired property provided in most loan documents is cut off as of the bankruptcy filing date — though the lender retains its lien on accounts receivable generated before the filing date, even if they are collected after the bankruptcy is commenced. As such, it is advisable for Chapter 11 providers and their lender to enter into cash collateral agreements subject to bankruptcy court approval, which typically provide for adequate protection payments and a

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Hiding Assets in California

By David Goodrich

The vicissitudes of consumer fortune appear to have led to the "asset protection" industry. A cursory Internet search of the phrase, "asset protection" produces pages of advice for "protecting" assets from creditors and, ostensibly, from bankruptcy trustees. Often, asset protection advice is bereft of any discussion of California exemption statutes — which often provide the most efficient and safest asset protection — and fails to admonish the unwary of powerful creditor rights. Most asset protection discussion forums ignore the consequences of a Chapter 7 bankruptcy filing should asset protection countermeasures be deployed in response to a creditor's asset-hungry appetite. Ironically, some asset protection tools leave assets completely naked, and strip them of any protection afforded under exemption statutes.

As a preliminary matter, it may be useful to understand a common pitfall of most asset protection tools used in California. If a transfer of property of a debtor is actually or constructively fraudulent, it is recoverable by a bankruptcy trustee if made within two years of a bankruptcy filing pursuant to 11 U.S.C. § 548, or within four years of a bankruptcy filing under California Civil Code (Cal. Civ. Code) §§ 3439.04 or 3439.05. If, however, the debtor owes the IRS back taxes, the reach-back period for a bankruptcy trustee could be 10 years depending on the length of delinquency to the IRS. *Mukamal v. Citibank NA* (*In re Kipnis*), 16-1045 (Bankr. S.D. Fla. Aug. 31, 2016)

The real trouble for a debtor begins after property is recovered by a bankruptcy trustee. Under 11 U.S.C. § 522(g), if a transfer of property is avoided and the initial transfer was voluntarily made by the debtor, the return of the asset to the bankruptcy estate bars the debtor from exempting the recovered asset. 11 U.S.C. § 522(g). The asset, which may once have been protected by an exemption statute, is no longer protected after it is recovered and it is susceptible to liquidation by a bankruptcy trustee.

While there are a variety of asset protection tools, the three most common tools are discussed in this article. It is important to note, however, that nearly all asset protection tools fail because of the one-two combination of the right-hand jab of 11 U.S.C. § 548/Cal. Civ. Code §§ 3439.04/3439.05 and the left-hand upper-cut of § 522(g).

Trusts

A trust is defined as an equitable or beneficial right or title to land or other property, held for the beneficiary of the trust by another person, in whom resides the legal title or ownership, recognized and enforced by courts of chancery. *See* Black's Law Dictionary. Trusts can be revocable or irrevocable; the former permits a return of an asset to the trustor upon revocation of the trust, while the latter transfers ownership of trust assets to the trust.

Under California law, property of a revocable trust can be levied by creditors of the settlor. California Probate Code § 18200; *In re Brooks-Hamilton*, 348 B.R. 512, 519 (Bankr. N.D. Cal. 2006); *In re Irwin*, 338 B.R. 839, 854-53 (E.D. Cal. 2006). Similarly, property transferred to a revocable trust constitutes property of the settlor's bankruptcy estate. *In re Cutter*, 398 B.R. 6, 19 (9th Cir. BAP 2008), citing *Askanase v. LivingWell, Inc.*, 45 F.3d 103, 106 (5th Cir. 1995). In short, revocable trusts offer no protection for assets in a bankruptcy case.

Irrevocable trusts, on the other hand, offer some asset protection because property of a trust is not generally considered bankruptcy estate property. *United States v. Lawrence*, 189 F.3d 838, 845 (9th Cir. 1999). That said, however, the powers a debtor may exercise under a trust for his or her own benefit do become property of the estate. *Askanase* at 106. Moreover, to the extent a debtor holds a beneficial interest in a trust, that beneficial interest becomes property of the bankruptcy estate. 11 U.S.C. § 541(a)(1) and (c)(2).

Notwithstanding the seemingly impenetrable wall of asset security an irrevocable trust appears to provide, assets of an irrevocable trust are not safe if the trust is self-settled. Assets held in a self-settled trust (a trust that designates the trustor as the beneficiary) are property of a bankruptcy estate because under California law, a settlor of a trust cannot also act as beneficiary of that trust. *See* California Probate Code § 15304(a). California law voids self-settled trusts to prevent individuals from placing their property beyond the reach of their creditors while at the same time still reaping the bounties of such property. *See Nelson v. California Trust Co.*, 33 Cal. 2d 501, 202 P.2d 1021, 1021 (Cal. 1949). Where a trust is invalid, assets of the trust become property of a bankruptcy estate. *Lawrence* at 845.

Irrevocable trusts may protect assets when the trust is not self-settled and a valid spendthrift clause exists. A spendthrift clause is a provision in a trust that prohibits the beneficiary of the trust from transferring his or her right to future payments of income or capital. California law recognizes the validity of spendthrift trusts. *See In re Neuton*, 922 F.2d 1379 (9th Cir. 1990) (citing California Probate Code §§ 15300 *et seq.*). Where a spendthrift trust is valid, most or all of the property of the trust is protected from creditors. The critical inquiry in determining whether a spendthrift trust is valid under California law is whether the trust's beneficiaries are able to exercise excessive control over the trust. *See In re Witwer*, 148 B.R. 930, 937 (Bankr. C.D. Cal. 1992). California law does not allow a participant with excessive control over a trust to shield that trust with an anti-alienation provision lacking true substance.

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Recently, a significant blow was dealt to trust-lovers throughout California. On March 23, 2017, the California Supreme Court held that a bankruptcy trustee could seize property of an irrevocable trust, notwithstanding the existence of a valid spendthrift clause, once "principal" becomes due and payable to the beneficiary/debtor. *Carmack v. Reynolds*, 2017 Cal. LEXIS 2429 (2017). Consequently, trust property that becomes due and payable to a beneficiary may no longer be protected by a trust's spendthrift clause in California, and can be seized by creditors or a bankruptcy trustee.

Assuming a valid spendthrift clause exists and the property of the trust is not due and payable to the beneficiary/debtor, assets held in a trust may still be in jeopardy. This is because of the trustee's avoidance powers under 11 U.S.C. §§ 544, 548 and Cal. Civ. code §§ 3439.04 and 3439.05. *See United States v. Carter*, 2010 U.S. Dist. LEXIS 52732 (S.D. Cal. 2010). Most trusts are a one-way street; assets flow into the trust, but nothing is given back to the settlor. Because of this, most transfers of property to a trust are avoidable as actually or constructively fraudulent transfers.

Under the correct circumstances, assets placed in a trust are protected from liquidation. There are, however, a number of hurdles to establishing a bullet-proof trust. And should a transfer of property be avoidable, the return of an asset to the bankruptcy estate will bar the debtor from exempting the asset. *See* 11 U.S.C. § 522(g).

Business Entities

Entities such as corporations and limited liability companies are also popular asset protection tools. They are so popular that television and radio stations relentlessly trumpet the importance of incorporating for the purpose of protecting assets and loved ones. But are corporate coffers insulated from a bankruptcy trustee?

Stock owned by a debtor is property of a bankruptcy estate. *See* 11 U.S.C. §541(a); *Milden v. Joseph* (*In re Milden*), 1997 U.S. App. LEXIS 7726 (9th Cir. Cal. Apr. 16, 1997), an unpublished Ninth Circuit opinion citing *In re Baker*, 68 Bankr. 360, 363 (D. Or. 1986) (which found the corporation itself was property of the estate because it was wholly owned by the debtors); *United States v. Ken Int'l. Ltd.*, 184 Bankr. 102, 107 (D. Nev. 1995); *In re Deak & Co.*, 63 Bankr. 422, 427 (Bankr. S.D.N.Y. 1986); *In re MacDonald*, 114 Bankr. 326, 333-34 (D. Mass. 1990).

If a business entity has little or no debt, then a sale of stock of the entity will, in most cases, result in a sale price equal to the value of the assets held in the business entity. Although a debtor may assert an exemption to the stock of the entity, that exemption is limited. *See* California Code of Civil Procedure §§ 703 *et seq.* and 704 *et seq.* For example, if real estate is held in the name of a corporation, a debtor is not entitled to claim a homestead exemption of $75,000, $100,000 or $175,000 (which would ordinarily be the case if the property is held in the debtor's name). Instead, a debtor is limited to the "wildcard" exemption. Unlike the generous amounts provided under the California homestead exemption, the "wildcard" exemption caps out at $26,925. Further, the wildcard exemption only affixes to the stock of the entity and not the assets of the entity. In the context of a bankruptcy case, holding assets in a business entity may provide less protection than holding assets in the debtor's name.

Also, if allowed by corporate bylaws, a trustee may be able to vote himself or herself director of the entity and can control, without restriction, the entity's fate. For example, the trustee could file a bankruptcy petition to have the entity's assets liquidated by a fellow trustee, with the nominal debts of the entity paid and the resulting equity turned over to the individual debtor's bankruptcy trustee. A bankruptcy trustee could also file a complaint for involuntary dissolution of the entity, seek a receivership over the corporation's assets or assign the assets of the entity to a third party for the benefit of its creditors. And if that does not work, the trustee could seek substantive consolidation of the entity into the individual debtor's bankruptcy case and gain control over all of the entity's assets.

In addition to the problems mentioned above, corporate assets are subject to a bankruptcy trustee's strong-arm powers provided under 11 U.S.C. § 548 and Cal. Civ. Code §§ 3439.04 and 3439.05. Entities designed to hold assets typically accept assets in the form of capital contributions. But capital contributions made without any value in return are nothing more than transfers that are avoidable. If the transfer of property is avoided, a business entity designed to protect assets provided no protection for the assets.

Marital Agreements

In California, assets of spouses can be divided during marriage by agreement. But assets transferred in California under a martial agreement are subject to avoidance under 11 U.S.C. § 548 and Cal. Civ. Code §§ 3439.04 and 3439.05. *Mejia v. Reed*, 31 Cal. 4th 657 (2003), (holding that property voluntarily transferred under a marital settlement agreement is subject to avoidance under Cal. Civ. Code §§ 3439.04 and 3439.05).

Moreover, a release of child or spousal support is no longer adequate consideration for a transfer of an interest in property. *Carbaat*, 357 B.R. 553 (Bankr. N.D. Cal 2006) (noting the definition of "value" under 11 U.S.C. § 548(d)(2)(A) and Cal. Civ. Code § 3439.03 excludes an unperformed promise to provide future support to the debtor or to another person); *Hahn v. Leong* (*In re Llamas*), 2011 Bankr. LEXIS 4779 [*40] (Bankr. C.D. Cal. Dec. 12, 2011) (holding the transfer of property in exchange for a release from an obligation to pay support was is not adequate consideration for purposes of satisfying "value" required under 3439.04 and 3439.05).

As a result of the holdings in *Carbaat* and *Llamas*, property transferred to a spouse can be recovered by a bankruptcy trustee if

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a waiver of spousal support is the "value" provided. And if the property is recovered because a transfer was avoided, it cannot be exempted. 11 U.S.C. § 522(g).

Conclusion

Asset protection can be foolish and costly. To properly protect an asset in California, it's generally best to understand and maximize exemptions. Most "asset protection" advice is free. You often get what you pay for. Sometimes less.

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negotiated budget, and may also include replacement liens on the provider's receivables and cash generated after the bankruptcy filing.

A Fight over Where to Fight with Payers

Outside of bankruptcy, the federal government and its contractors routinely withhold Medicare and Medicaid payments upon determining that a healthcare provider has been overpaid on a prior unrelated reimbursement claim. Under 42 U.S.C. § 405(h), federal courts may take jurisdiction over Medicare disputes only after a party exhausts applicable appeal processes within the Medicare system. A provider affected by a similar regulatory decision by the government — such as termination of a Medicare provider agreement — also faces this same obstacle. A financially unstable provider cannot survive this interim period of appeals without these reimbursements.

Healthcare providers file Chapter 11 to preserve or maximize the ongoing value of their assets and operations, which includes expediting judicial review of debtor-creditor matters, curing any alleged defaults and obligations, and administering or repurposing assets via third-party transactions. However, the federal courts (up through the circuit courts of appeal) are split regarding the plain language of 42 U.S.C. § 405(h) as it relates to bankruptcy courts' jurisdictional limitations, thus impacting a provider's protections in Chapter 11.

Section 405(h) only references 1331 and 1336 of Title 28 of the United States Code, and does not refer to Section 1334 of Title 28 (which grants bankruptcy court jurisdiction). Some circuit courts of appeal apply a strict application of the statute's plain language and the absence of a Section 1334 reference in prior Congressional amendments to determine that a requirement to exhaust administrative remedies is inapplicable in bankruptcy cases.

Other circuit courts of appeal look to the relatively clear legislative history to imply an intent that an exhaustion of administrative remedies applies even in federal bankruptcy court. A provider in bankruptcy currently has a petition on file with the United States Supreme Court for certiorari review of this issue, though the Court may not accept review.

Forum disputes also exist between network providers in bankruptcy and their private insurance payers, as most contracts contain arbitration clauses and administrative remedies provisions. There is some disagreement by courts as to the enforcement of arbitration clauses in this context, many times dependent on whether the underlying dispute is a "core" bankruptcy issue, which tends to remain in bankruptcy court like the sale of an asset or claims objection, or is a non-core matter such as a garden-variety breach of contract type claim, which generally gets sent to arbitration.

Payer Take-Backs As Setoffs Or Recoupment

The government system regarding Medicare and Medicaid payments differs meaningfully from the private insurance company payments for HMO, PPO, POS and other Exchange insurance products. For instance, government payments to providers are made on an interim basis under a prospective reimbursement system, which results in payments before a determination that the services rendered are covered and costs are reasonable.

Fiscal intermediaries subsequently audit claims for reimbursement, for a period of up to several years from the date of submission, to determine the appropriateness of payments requested and made. If, after completion of the audit, the fiscal intermediary determines that a provider has been overpaid, the government has the right to recover the overpayments from the provider.

Due in large part to the prospective payment system, more courts than not find that the subsequent take-backs are recoupments as part of a single, integrated and ongoing transaction between the government and the payer — though there is still some differing circuit-level law across the country.

In the private insurance company setting, payments are not made on a prospective reimbursement system where claims are vetted and approved prior to initial payment. Yet, there are instances of payment error, which trigger requests for overpayment reimbursement. When the matter remains unresolved, many insurance company payers resort to unilateral take-backs where they apply their asserted reimbursement overpayment against a more recent valid claim of an unrelated patient. Thus, the private insurance company payers seemingly have a weaker argument to support that these take-backs are recoupments instead of a setoff.

This distinction between setoff and recoupment is important because setoffs are subject to the Bankruptcy Code's automatic stay (and generally not subject to the exception to the automatic stay for government enforcing its police and regulatory power), and generally setoff obligations fall within claims that can be sold free and clear in bankruptcy sales merely attaching

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to sale proceeds, but not applied against a bankruptcy purchaser of a provider license.

In addition, setoff may not be permitted by the court due to a lack of mutuality of obligation and otherwise would be deemed an improper postpetition recovery of a prepetition claim or otherwise violating the Bankruptcy Code's priority scheme for creditor distributions. Recoupments, however, are not subject to the automatic stay, the distribution scheme for creditors, and may not be discharged in a bankruptcy sale or plan confirmation — principally because under the recoupment doctrine these monies are deemed not to be property of the bankruptcy estate. However, payer recoupment actions remain an equitable defense remedy subject to judicial determination upon challenge by a provider.

For instance, some providers have argued that the imposition of unilateral take-backs by a payer — even if deemed as recoupment — is an impermissible violation of the anti-discrination provision of Bankruptcy Code Section 525. For example, in the Medicare context, provider debtors have argued that they cannot be compelled to pay prepetition obligations to the government as a condition for continued participation in the Medicare program during their bankruptcy.

A Fight Worth Fighting For

The relationship between the Medicare/Medicaid programs and providers is captured in a written provider agreement. These agreements afford providers with a license/number to participate in the Medicare/Medicaid prospective reimbursement program. The licenses are not made available for everyone who submits an application. In this way, they are much like a liquor license or a taxicab medallion, in that there are a finite number made available at a given time — making them a relatively scarce commodity to purchasing providers who want to break into a new geographic market.

Disputes arise when the provider seeks a sale of assets in bankruptcy, including the provider number. The government's general position in bankruptcy is that the provider agreement is an executory contract subject to the Bankruptcy Code requirement that its obligations (the overpayments) must be cured before it can be assumed and assigned to a purchaser/assignee. In this way, it seeks to block the sale or impute successor liability until paid in full. The main policy argument is that a provider taking on the benefits of the prospective provider agreement must also take on the existing burdens as well.

Providers and purchasers tend to argue that the provider licenses/numbers are not executory contracts, but are licenses/assets that can be sold free and clear of the overpayment obligations existing at the time of the sale. The general rationale is that the provider license is not a negotiated agreement like most contracts, but is a regulatory form application that is completed and approved by the government. Also, a ruling requiring a cure prior to assumption/assignment or of potential successor liability either would block the sale or greatly diminish the value of the assets, impeding an ability to maximize value for case constituents.

Even if the provider license is not deemed to be an executory contract, if the overpayment recovery actions are deemed a recoupment, then more cases than not hold that a 363 sale still could not extinguish that claim against the purchaser. Consequently, many times settlements are reached and work-arounds are accomplished, such as setting up a portion of the sale proceeds in escrow or setting up a waterfall overpayment recovery scheme.

This process might recover first against that payer's payments due to the debtor's estate, next from funds held by the bankruptcy estate if generated by previous interim payer payments, then against any sale proceeds generated by the sale of the provider number, and finally only as needed against the entity to which the provider number is assigned — and some purchasers have negotiated annual, budgeted caps in connection with same. However, the lack of certainty and the need to spend money in litigation greatly diminishes the value of these assets and otherwise deteriorates their market.

Conclusion

Healthcare provider Chapter 11 cases are multi-faceted and include additional parties and issues than in standard Chapter 11 cases. A financially distressed provider considering Chapter 11 should find a properly vetted stalking-horse deal partner prior to filing the case, and engage in meaningful discussions with their payers and lenders, if possible.

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fraud's proceeds between their bank accounts.

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

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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 account-holder'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

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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 non-exempt 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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