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Client Alert

Financial Restructuring Practice Group

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Williams v. FDIC (In re Positive Health Management) Lender Forced to Return Payments Made by Non-Borrower

On October 16, 2014, the United States Court of Appeals for the Fifth Circuit entered an order requiring a real estate lender, First National Bank (the "**Lender**"), to refund certain mortgage payments it received from Protective Health Management (the "**Debtor**"), an affiliate of its borrower.[1] Because the mortgage payments constituted actual fraudulent transfers, the Fifth Circuit held that the Lender could retain the payments only *to the extent* of the value of the Debtor's continued use of the property.[2] Like the Eleventh Circuit's controversial ruling in the *TOUSA* bankruptcy, this case serves as an important reminder that lenders should monitor the source of debt payments.

Background

In 2006 the Lender made a loan to Zeigler Enterprises III, LLC (the "**Borrower**") (an entity owned by Robert Zeigler). The loan was secured by a first lien mortgage on an office building owned by the Borrower. The Debtor (a pain management clinic also owned by Mr. Zeigler) occupied the office building, but was neither a borrower nor a guarantor under the Lender's loan. From February 2007 through March 2008, the Debtor made direct payments to the Lender on account of the loan totaling approximately $365,000; the Debtor's tax returns described these payments as "rent." Although the Borrower was in default, the Lender did not pursue collection efforts or a foreclosure while the Debtor made the payments.

Beginning in 2006, the Debtor stopped paying employment tax liabilities; instead, Mr. Zeigler used the funds "to maintain his own lavish lifestyle."[3] Facing significant unfunded tax liabilities, the Debtor filed a voluntary petition under Chapter 11 of the Bankruptcy Code in March 2008. The case was subsequently converted to a case under Chapter 7, and a trustee was appointed.[4] The trustee brought an adversary proceeding against the Lender asserting that the payments made by the Debtor to the Lender constituted fraudulent transfers under Section 548 of the Bankruptcy Code.

Bankruptcy Court Opinion

The Bankruptcy Court found that the Debtor made the transfers with the actual intent to hinder, delay, or defraud its creditors.[5] Notwithstanding the Debtor's actual fraudulent intent, the Lender argued that it was entitled to the affirmative defense set forth in Section 548(c) of the Bankruptcy Code, which

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allows a transferee that takes in good faith to retain the property transferred by the Debtor "to the extent that such transferee . . . gave value to the debtor in exchange for such transfer."[6]

In evaluating the Lender's defense under Section 548(c), the Bankruptcy Court applied a two-pronged analysis: (a) did the Lender act in good faith; and (b) did the Lender give value in exchange for the payments? With respect to the good faith prong, the Bankruptcy Court concluded that the Lender acted in good faith because it "neither knew, nor should have known, that the Debtor was making questionable transfers."[7] As for value given, the Bankruptcy Court concluded that the Lender provided reasonably equivalent value in the form of the Debtor's continued use of the property. The Borrower was in default, and had the Lender foreclosed, the Debtor would have been evicted. Based on testimony and evidence presented at trial, the Bankruptcy Court concluded that the value related to the Debtor's continued use of the property equaled approximately $250,000, which was reasonably equivalent to the $365,000 in payments made to the Lender. Because the Lender acted in good faith and gave reasonably equivalent value, the Bankruptcy Court held that the Lender was entitled to retain the full amount of the payments.[8]

The Fifth Circuit Court of Appeals Opinion

On appeal, the Chapter 7 trustee argued that Section 548(c) affords an affirmative defense for good faith only "*to the extent* that such transferee . . . gave value to the debtor in exchange for such transfer"[9] and that as a result, the Bankruptcy Court should have offset the value received by the Debtor ($250,000) against the payments made to the Lender ($365,000) and required the Lender to return any excess.

The Fifth Circuit observed that courts have reached different conclusions on this point—some, like the Bankruptcy Court in this case, have held that a transferee acting in good faith escapes all liability so long as it gave reasonably equivalent value, but other courts have applied a "netting" approach allowing a transferee to retain payments only up to the value given to the debtor. The Fifth Circuit adopted the "netting" approach, concluding that "[t]he last clause of the statute, beginning with 'to the extent,' makes clear that a transferee is entitled to keep only the amount of a fraudulent transfer that equals the amount it gave up in exchange."[10] Accordingly, the Fifth Circuit held that the Chapter 7 trustee was entitled to recover approximately $115,000 (*i.e.*, the difference between the payments made to the Lender and the value related to the Debtor's continued use of the property).

Lessons Learned

The *Protective Health Management* decision serves as a reminder to secured lenders that it is increasingly necessary to monitor the source of payments. A red flag should be raised anytime payment comes from a party other than the borrower. If the Debtor's "rent" payments had gone first to the Borrower and then the Borrower used the funds to pay its obligations to the Lender, the Lender would not have faced liability for a fraudulent transfer. Understandably, most lenders are content to receive timely payments regardless of the source. However, as illustrated by this case, that approach can lead to potential fraudulent transfer liability and costly litigation.

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[1] *Williams v. Federal Deposit Ins. Corp. (In re Protective Health Mgmt.)*, Case No. 12-20687, 2014 U.S. App. Lexis 19883 (5th Cir. Oct. 16, 2014) ("*5th Cir. Op.*").

[2] *Id.* at *22.

[3] *Williams v. BBVA Compass Bank (In re Protective Health Mgmt.)*, Adv. Pro. No. 10-03121, 4 (Bankr. S.D. Tex. Sept. 20, 2011) ("*Bankr. Op.*").

[4] *Id.* at 6.

[5] *Id.*

[6] *See* 11 U.S.C. § 548(c).

[7] Bankr. Op. at 28.

[8] *Id.* at 30.

[9] 11 U.S.C. § 548(c) (emphasis added).

[10] 5th Cir. Op. at *18.