



The Section 548(c) Defense to Fraudulent Transfers in Bankruptcy Cases



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Section 548 of the Bankruptcy Code allows a bankruptcy trustee to recover fraudulent transfers made by the debtor prior to the filing of the bankruptcy case.¹ However, a transferee that accepted the transfer in good faith is permitted to retain the transfer, to the extent the transferee gave value to the debtor in exchange.² Value given to the debtor “must be assessed from the perspective of what the transferee gave up rather than what the debtor received.”³ “Good faith” is an affirmative defense which the transferee needs to timely plead as a defense and then bear the burden of proof and persuasion.

The Fifth Circuit Court of Appeals recently addressed whether a transferee that received more from a transfer than it gave to the debtor in return is allowed to retain the difference in value, or if a netting approach where the transferee is required to return the difference in value to the bankruptcy estate should be applied.⁴

In *Williams v. FDIC*, the debtor, Positive Health Management (“PHM”), operated pain management clinics in Texas. The Debtor’s president and sole shareholder also owned a separate corporate entity. The separate entity owned an office building, which it used as collateral for a refinance loan from First National Bank in 2005. From 2006 to 2008, PHM used the office building for its offices. From February 2007 to March 2008, PHM made a series of payments to First National Bank, although PHM had no direct obligations under the refinance loan. PHM claimed the payments as rent on its tax returns.

After PHM filed bankruptcy, the chapter 7 trustee brought an adversary proceeding to recover PHM’s payments to First National as actual or constructive fraudulent transfers under 11 U.S.C. § 548.

The bankruptcy court found that there was no constructive fraudulent transfer under 11 U.S.C. § 548(a)(1)(B) because PHM received value at least “reasonably equivalent” to the amount of the transfers to First National Bank.⁵ The bankruptcy court then determined that PHM made the transfers “with actual intent to hinder, delay, or defraud” and, as a result, the transfers were actual fraudulent transfers under 11 U.S.C. § 548(a)(1)(A).⁶ However, because First National Bank established that it took the payments in good faith and gave value in return, the bankruptcy court determined that First National Bank was entitled to a defense under 11 U.S.C. § 548(c) and could retain the transferred funds.⁷ The district court affirmed, and the case was appealed to the Fifth Circuit Court of Appeals.⁸

On appeal, the chapter 7 trustee argued that the section 548(c) defense applies only to the extent of the value given to the Debtor and that the court should reduce the value of the fraudulent transfers to First National Bank by the market value of the rent (the value given up by First National Bank) and award the remainder to the bankruptcy estate.⁹

The Fifth Circuit agreed and concluded that the text of section 548(c) supports the netting approach. “The last clause of [section 548(c)], 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 Thus, “[a] good faith transferee is entitled to the protections of *section 548(c)* when it gives *any* value in return, but only to the extent of that value. When a transferee receives a fraudulent transfer the value of which exceeds the consideration it gave up in return, *section 548(c)* requires netting.”¹¹

As for the method of valuation to be applied, the Fifth Circuit explains that “[b]ankruptcy courts may simply continue applying the tools they use to determine the value of assets in many contexts to determine value under *section 548(c)*.”¹²

The Fifth Circuit reversed the bankruptcy court’s take-nothing judgment in favor of First National Bank and rendered a judgment in favor of the chapter 7 trustee in the amount of \$114,385.02, the difference between the value of the transfers to First National Bank (totaling

\$367,681.35) and the market value of the rent (determined to be \$253,333.33).¹³ One key lesson for any transferee in any remotely similar situation, including a lender receiving payments on its debt, might be to keep good records of the value given, the value received, and of the transferee's good faith. The burden of proof in each instance may fall on the innocent.

1. 11 U.S.C. § 548(a).
2. 11 U.S.C. § 548(c).
3. *Williams v. FDIC (In re Positive Health Management)*, 769 F.3d 899, 899 (5th Cir. 2014) (citing *Jimmy Swaggert Ministries v. Hayes (In re Hannover Corp.)*, 310 F.3d 796, 799-802 (5th Cir. 2002)).
4. *Williams*, 769 F.3d at 899.
5. *Id.* at 902.
6. *Id.*
7. *Id.* at 902-03.
8. The bankruptcy court's finding that the transfers were made with actual intent was not seriously challenged on appeal. *Id.* at 902.
9. *Id.* at 906.
10. *Id.* at 907 (citing *Hannover*, 310 F.3d at 802).
11. *Id.* at 908-09 (emphasis in original).
12. *Id.*
13. *Id.*