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Judicial Cross-Currents in Debtor and Creditor Law §278

In his legendary article in Volume 10 (1897) of the *Harvard Law Review*, "The Path of the Law," Oliver Wendell Holmes reduced the law to its essence as a predictive tool for businessmen: "The object of our study…is prediction, the prediction of the incidence of the public force through the instrumentality of the courts." Holmes was not as quick to acknowledge, however, that his adored system of the common law is not always the best designed means to attain such predictability. Legitimate disagreements aside, the multiplicity of judicial opinion-making across concurrent federal and state jurisdictions can sometimes lead to divergent "paths."

The law of fraudulent conveyances, codified in the New York Debtor and Creditor Law (DCL), offers a striking example of just such judicial cross-currents. Although the main body of this law offers calm waters to the prospective litigant seeking smooth sailing, one stretch of those waters could create some unforeseen turbulence: the law on liability of transferees and beneficiaries of fraudulent conveyances. In that context, two federal court decisions have muddied the waters with idiosyncratic interpretations that are in stark conflict with state court pronouncements.

The Law of Fraudulent Conveyances

The current law of fraudulent conveyances in New York dates back to 1925. While the Uniform Law Commission introduced the Uniform Fraudulent Transfer Act (UFTA) in 1984, this statute was never adopted by New York state. Decades later, in 2014, the Uniform Law Commission devised yet another version of the law, the Uniform Voidable Transactions Act (UVTA). This time the New York legislature embraced legal progress and enacted the law in December 2019. Effective as of April 4, 2020, the statute is not retroactive. For all transactions prior to the effective date, the old legal regime still obtains, and thus this established body of law will continue to be relevant for years to come.

This article focuses on the state of the law under the old DCL. Under that regime, a creditor is entitled to recover fraudulent conveyances from "*any person*, except a purchaser for fair consideration without knowledge of the fraud at the time of the purchase." DCL 278 (emphasis added). In other words, transfers made for valid consideration and in good faith are exempt from avoidance.

Court of Appeals Sets the Standard

The leading New York case on transfers in furtherance of fraudu-


Courtesy Photo

Alexander Shapiro.

lent conveyances is the 1990 Court of Appeals decision in *Federal Deposit Ins. Corp. v. Porco*, 75 N.Y.2d 840 (1990). In that case the receiver of an insolvent bank obtained a $6 million judgment against the director of the bank. In an ancillary lawsuit, the receiver filed claims against two additional bank officers, alleging that they were liable for assisting the director in transferring funds offshore to Switzerland. The officers moved to dismiss the complaint. The trial court denied the motion.

On appeal, the Court of Appeals reversed the trial court's decision, holding that merely assisting in a fraudulent transfer did not establish liability. As the court explained, §278 of the DCL "did not, either explicitly or implicitly, create a creditor's remedy for money damages against parties who, like defendants here, were neither transferees of the assets nor beneficiaries of the conveyance." By this negative formulation, the Court of Appeals limited the scope of "any person" in §278 to transferees and beneficiaries of fraudulent conveyances, and the liability of such persons to the amount of money received.

Later in the opinion, the court amplified its holding thus: "the statute still cannot fairly be read as creating a remedy against nontransferees who, like defendants here, are not alleged to have dominion or control over those assets or to have benefited in any way from the conveyance." Implicit in this statement was a simple test: If the individual had "dominion or control" over the assets, or benefitted in some way from the improper transfers, he or she could be held liable under the fraudulent conveyance law.

Unaddressed, but certainly understood, was the provision of §278 excusing bona fide purchasers for value. But the court's silence on this exception in the context of a motion to dismiss leads to the conclusion that while such a defense is available it is not necessary for the plaintiff to rebut it at the pleading stage. *Porco* has now become the bedrock authority for holding transferees and beneficiaries liable for fraudulent conveyances.

Second Circuit Muddies the Waters

Confusion almost immediately ensued, however, when the U.S. Court of Appeals for the Second Circuit purported to paraphrase the *Porco* ruling in *Stochastic Decisions v. DiDomenico*, 995 F.2d 1158 (2d Cir. 1993). In that case, Circuit Judge John Mahoney, speaking for the three-judge panel, held that, "[t]he New York Court of Appeals has made it clear that the pertinent provisions of the New York Debtor and Creditor Law provide a creditor's remedy for money damages against parties who participate in the fraudulent transfer of a debtor's property and are transferees of the assets and beneficiaries of the conveyance." With this formulation, the Second Circuit, far from clarifying the law of the state, added an aggressive gloss to the *Porco* court's relatively simple rule.

Whereas the Court of Appeals had found that transferees who have dominion and control over the assets, or are beneficiaries of such assets, are subject to a rebuttable presumption of liability, Judge Mahoney transformed the test into a two-part analysis: To be held liable, individuals must not only (a) be transferees and/or beneficiaries; but must also (b) *participate* in the fraudulent transfer. What such "participation" meant, and how it differed from the act of transfer itself was left completely unexplained.

Two District Courts Take 'Stochastic' in Opposite Directions

'Sullivan v. Kodsi' (S.D.N.Y. 2005): For many years, courts paid deference to this federal formulation while doing precious little to interpret it. Twelve years later, it fell to then District Judge Gerald Lynch, now of the Second Circuit, to follow through on the implications of the test. In *Sullivan v. Kodsi*, 373 F. Supp. 2d 302 (S.D.N.Y. 2005), Lynch read the *Stochastic* rule at face value, holding that not only must a plaintiff prove that the defendants are beneficiaries and/or transferees of fraudulent conveyances but that they have "participated" in the fraudulent transfer. While conceding that "ordinarily it might be difficult for a transferee or beneficiary to be distinguished by definition from a participant in the transfer," Lynch, like many of his predecessors, shied away from explaining just what he meant by "participation." The contours of a definition, however, can be discerned from the court's analysis.

In *Kodsi*, plaintiffs accused Alain Kodsi of avoiding millions of dollars in debt through fraudulent conveyances to the Kodsi Family Trust, which he had established for the benefit of his mother, wife and daughter. The creditors accordingly sued not only Kodsi, but the trustee, Louis Greco, and the mother and wife as beneficiaries of the Trust. Judge Lynch dismissed the case against all of these "transferee" defendants, finding that the plaintiffs had insufficiently alleged their "participation" in the fraudulent transfers.

With respect to Greco, while conceding that he had "acquiesced in the trust's fraudulent purpose," the judge found that he could not be held responsible for participating in the transfers insofar as he had succeeded to the role of trustee almost four years after the transfers had taken place. As for the beneficiaries, Judge Lynch found no "participation" because the assets had not been "directly transferred into the hands of the Trust's beneficiaries," and that the complaint did not "speak at all to the knowledge on the part of the beneficiaries of the exact alleged circumstances of the transfers and/or Alain Kodsi's finances at the time of the transfers."

Judge Lynch's interpretation, while trying to be true to the *Stochastic* formulation, imported a set of hurdles that are not to be found in the Debtor and Creditor Law. First, the requirement that Greco be involved in the transfers at the time they were made added a timeliness factor to the "dominion and control" rule found sufficient by the *Porco* court.

Second, the apparent requirement that the funds be transferred directly into the hands of the beneficiaries as opposed to a trust for their benefit—ostensibly in order to establish "participation"—appears to vitiate the entire import of the "beneficiary" prong of the *Porco* test.

Finally, by requiring that the plaintiff establish some level of knowledge of the circumstances on the part of the beneficiaries, Lynch again went beyond *Porco* by imposing an affirmative scienter requirement at the pleading stage. But DCL 278 exempts the transferee/beneficiary only if he or she is *both* a "purchaser for fair consideration" and "without knowledge of the fraud at the time of the purchase."

Thus, if there is no fair value exchanged, as was the case in *Kodsi*, then state of mind should not even enter the analysis. And certainly, under well-established New York law, the familial connection of the beneficiaries to the debtor carries with it a presumption of fraud. See, e.g., *Wall Street Assocs. v. Brodsky*, 257 A.D.2d 526, 528 (1st Dep't 1999).

'Fundacion Presidente Allende v. Banco de Chile' (S.D.N.Y. 2006): One year after *Kodsi* was decided, however, another District Judge of the Southern District of New York, Judge George B. Daniels, took the *Stochastic* rule in completely the opposite direction. In *Fundacion Presidente Allende v. Banco de Chile*, 2006 WL 2796793, at *3 (S.D.N.Y. May 29, 2006), Daniels cited *Stochastic* for the proposition that "[a] fraudulent conveyance claim seeking to recover money damages can only be maint ained against a person who participates in the fraudulent transfer as either the transferee of the assets or the beneficiary of the conveyance."

With a subtle twist of verbiage, Judge Daniels completely eliminated *Stochastic*'s double-barreled standard. In Daniels' formulation, the problematic "and" in *Stochastic* was transformed into an "as." Instead of "parties who participate in the fraudulent transfer of a debtor's property *and* are transferees of the assets and beneficiaries of the conveyance," *Fundacion* substitutes "a person who participates in the fraudulent transfer *as* either the transferee of the assets or the beneficiary of the conveyance."

Thus, the two-part test of *Stochastic* was reformulated as the one-part test that had originally been contemplated by the Court of Appeals. In other words, the ostensibly independent requirement of "participation" becomes defined by the transfer itself; one "participates" only to the extent that one has "dominion or control over the assets or derived any benefit from the conveyance." *Fundacion*, 2006 WL 2796793, at *3.

Tension Remains

Was Judge Daniels' reformulation of the *Stochastic* rule intentional or a mistake in transcription? To add to the mystery, the second citation in that case after *Stochastic* was *Kodsi*! No matter, these two competing standards now live, in unresolved friction, side by side. Compare, e.g., *Chemtex v. St. Anthony Enterprises*, 490 F. Supp. 2d 536, 548 (S.D.N.Y. 2007) (applying *Fundacion* construction) with *In re Vivaro*, 524 B.R. 536, 559-61 (Bankr. S.D.N.Y. 2015) (applying *Kodsi* formulation). One district court judge has noted in passing the contrasting approaches, *United States v. Lax*, 414 F. Supp. 3d 359, 369 (E.D.N.Y. 2019) (identifying "split of authority"), but that is all.

As for the New York state courts, the impact of *Kodsi* is barely perceptible. I have found only one case that references it, but only for the proposition that liability of the transferee is limited to the amount of funds received: *Piccarreto v. Mura*, 51 Misc.3d 1230(A) (N.Y. Sup. Ct. 2016). But state courts have not remained entirely aloof from the controversy. *Stochastic* has climbed to a position of authority in the First Department.

For example, in 2003, in *Constitution Realty v. Oltarsh*, 309 A.D.2d 714 (1st Dept. 2003), the First Department pointed directly to *Stochastic* for the proposition that "[l]iability is imposed on 'parties who participate in the fraudulent transfer of a debtor's property and are transferees of the assets and beneficiaries of the conveyance.'" Id. at 716; see also *Schwartz v. Boom Batta*, 137 A.D.3d 512 (1st Dept. 2016). But none of these cases acknowledges the tension *Stochastic* creates with *Porco*.

To paraphrase Holmes again, this time his famous line in *The Common Law* (1881), the life of this particular law has been neither logic nor experience. It remains for the New York Court of Appeals to resolve the confusion with a definitive pronouncement on the requirements of DCL 278.

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