

RECOVERY OF “PERK” PAYMENTS AS FRAUDULENT TRANSFERS  
UNDER BANKRUPTCY CODE §§ 548(a)(1)(B) AND 550(a)

I. Introduction

It is not uncommon for an employer to provide a perk to an employee by making payments on the employee’s behalf. For example, an employer might make an employee’s car payments or pay the premiums on a life insurance policy owned by an employee’s family. The company that receives these payments (herein, the “provider”) – the auto finance company and the life insurance company in the foregoing examples – sees itself as blameless: it is merely receiving payment for the good or service it is providing.

As this article explains, however, if the employer ends up in bankruptcy, the payments might be avoided as fraudulent conveyances pursuant to Bankruptcy Code (“Code”) § 548(a)(1)(B).<sup>1</sup> And the result could be that the provider is forced, under § 550(a), to disgorge the payments. Such a result likely seems unfair from the provider’s perspective – again, the provider is merely accepting the payments it has earned – but it is authorized by the Code.

This article proceeds by first summarizing and analyzing § 548(a)(1)(B) – the avoidance provision – and reported cases that concern whether an employer received value sufficient to preclude the avoidance of payments made to a provider on an employee’s behalf as fraudulent conveyances. This article then addresses § 550(a) – the recovery provision – and reveals that a provider likely has no defense against an action to force the provider to return avoided payments.

II. § 548(a)(1)(B)

a. The Reasonably Equivalent Value Standard

Code § 548(a)(1)(B) allows a trustee to avoid “any transfer of an interest of the debtor in property, or any obligation incurred by the debtor” (hereinafter “transfer”) made within one year before the date of the filing of the petition upon a showing that the debtor received less than a reasonably equivalent value in exchange for the transfer and that the debtor (1) was insolvent on the date of the transfer or became insolvent as a result of the transfer, (2) was engaged, or was about to engage, in business or a transaction for which its remaining property was an unreasonably small capital, or (3) intended to incur, or believed that it would incur, debts that would be beyond its ability to pay as they became due.

The trustee bears the burden of proof on each of the elements, and the standard of proof is preponderance of the evidence. In re Empire Interiors, Inc., 248 B.R. 305, 307 (Bankr.N.D.Ohio 2000).

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<sup>1</sup> This article does not address the potential for such payments to be avoided under applicable state law or Code provisions that incorporate such law into a bankruptcy case.

Whether a debtor receives reasonably equivalent value for a transfer depends on all the circumstances surrounding the transfer. See, e.g., In re Morris Communications NC, Inc., 914 F.2d 458, 467 (4<sup>th</sup> Cir. 1990); In re North Babylon Estates, Inc., 30 F.2d 372 (2d Cir. 1928). This issue is largely factual, and considerable latitude is given to the trier of fact. See, e.g., In re Ozark Restaurant Equipment Company, 850 F.2d 342, 344 (8<sup>th</sup> Cir. 1988). It is clear, however, that “the focus is on the consideration received by the debtor, not on the value given by the transferee” and that “what constitutes reasonably equivalent value must be determined from the standpoint of the debtor’s creditors . . . .” In re Jeffrey Bigelow Design Group, Inc., 956 F.2d 479, 484 (4<sup>th</sup> Cir. 1992)(quoting Jack F. Williams, Revisiting the Proper Limits of Fraudulent Transfer Law, 8 Bankr.Dev.J. 55, 80 (1991)).

A corollary to the requirement that the focus be on “the consideration received by the debtor, not on the value given by the transferee” is that the transferee does not have to give value directly to the debtor; value given to a third party that benefits the debtor will suffice as long as the benefit to the debtor is reasonably equivalent in value to the transfer the debtor made. Id. at 485 (“[i]t is well settled that reasonably equivalent value can come from one other than the recipient of the payments . . . .”). This corollary is known as the “indirect benefit rule.” Id.

Therefore, the fact that a provider gives its good or service directly to the employee instead of the employer does not, by itself, mean that the employer’s payments to the provider are avoidable. All the circumstances surrounding the payments must be viewed to determine whether the employer received the requisite reasonably equivalent value. If the employer did not receive such value and the other criteria of § 548(a)(1)(B) are satisfied (e.g., the payments were made within one year before the petition date and the employer was insolvent on the date of the payments), then the payments can be avoided as fraudulent transfers.<sup>2</sup>

b. Bankruptcy Court Opinions

Two bankruptcy court opinions that address whether an employer received sufficient value in exchange for payments it made on an employee’s behalf are In re Worcester Quality Foods, 152 B.R. 394 (Bankr.D.Mass. 1993), and In re Complete Drywall Contracting, Inc., 11 B.R. 697 (Bankr.E.D.Pa. 1981).

In Worcester Quality Foods, the court addressed whether the debtor corporation received reasonably equivalent value for pre-petition payments it made toward, in pertinent part, expenses related to an airplane, two cars, and mobile telephones used by two of the debtor’s officers. 152 B.R. at 400-01. The court also addressed whether premium payments the debtor made on life insurance policies on the same two officers’ lives were in exchange for reasonably equivalent value. Id. at 401. The trustee had filed suit against the two officers and the debtor’s other controlling shareholders, directors, and officers, plus certain relatives and affiliates. Id. at 396.

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<sup>2</sup> For cases concerning the insolvency criterion of § 548(a)(1)(B), see In re Strickland, 230 B.R. 276, 282 (Bankr.E.D.Va. 1999), and In re Miller & Rhoads, Inc., 146 B.R. 950, 955 (Bankr.E.D.Va. 1992). For cases concerning the alternative “unreasonably small capital” criterion, see In re Vadnais Lumber Supply, Inc., 100 B.R. 127, 137 (Bankr.D.Mass. 1989), and In re Pioneer Home Builders, Inc., 147 B.R. 889, 894 (Bankr.W.D.Tex. 1992). For a case involving the “intended to incur debts beyond the ability to pay” alternative criterion, see In re Suburban Motor Freight, Inc., 124 B.R. 984, 1000 (Bankr.S.D.Ohio 1990).

The court decided that the debtor received no benefit from any of these payments. The court found that the officers used the cars and phones at issue almost exclusively for personal purposes. Id. at 401. With regard to the plane, the court had already found that the officers were not worth their salaries because, in short, their minimal efforts on the debtor's behalf were more than offset by bad business decisions they had made. Accordingly, the court stated that "[b]ecause the [principal's]. . .services were not worth the salary paid them, it follows that the Debtor received no benefit from this plane." Id. Finally, as to the premium payments, the court concluded that since the insurance policies were owned by a third party corporation, it was the third party, not the debtor, that received the benefit. Id.

Complete Drywall is a pre-Code case involving application of a state statute that rendered fraudulent any conveyance made "by a person who is or will be thereby rendered insolvent" unless the conveyance was made for a "fair consideration." 11 B.R. 699. The bankruptcy trustee was pursuing a principal of the debtor for pre-petition payments the debtor had made toward the principal's personal loans, home mortgage and utility bills, country club dues, and summer home rental. Id. The court found that the debtor did not receive fair consideration for repayment of the principal's personal loans because the principal offered no evidence of consideration. Id. at 700. In this regard, the court had placed the burden of proof on the principal because of his status as a fiduciary of the debtor under the applicable state law. Id. at 699-700.

The court found, however, that the debtor received fair consideration for its payments toward the principal's mortgage and home utility bills because the principal's residence was also used as a place of business for the debtor. Id. Further, the court found that payments toward the principal's summer home rental and country club dues were in exchange for fair consideration because they were part of the principal's compensation. Id. In this regard, the court relied on testimony by the principal and his accountant to the effect that (1) the principal's compensation consisted of cash salary and an amount regularly placed in a "loan and exchange" account out of which the payments in question were made, and (2) the principal paid income tax on the salary and the money placed in the loan and exchange account. Id. Finally, the court concluded that the principal's salary was not excessive. Id.

c. Analysis

Under Worcester Quality Foods and Complete Drywall, the analysis of whether an employer received reasonably equivalent value in exchange for payments it made on an employee's behalf involves two questions:

1. Were the payments made by the employer part of the employee's compensation?
2. If the answer to the first question is in the negative, then did the employer otherwise receive a benefit roughly equivalent in value to the payments it made?

In considering the first question, the factors that should be considered include how the payments were treated on the employer's books and tax returns, how the payments were treated

on the employee's tax return, and whether the employee's total compensation, including the payments in question, was excessive. As to the last factor, cases that provide points to be considered include Giannotti v. Hamway, 239 Va. 14, 26, 387 S.E.2d 725, 731-32 (Va. 1990) ("Regarding the issue of excessive compensation, the parties agree upon the factors to be considered in judging reasonableness. They include qualifications of the employee; the nature, extent, and scope of the employee's work; the type of services rendered; the difficulties involved in discharging responsibilities; success of the business; comparison between salary paid to the corporation's net income; comparison of compensation paid to comparable officers in other companies; and similar relevant factors."), and in In re Main, Inc., 242 B.R. 574, 587-88 (Bankr.E.D.Pa. 1999) ("the testimony of the responsibilities assumed, the difficulties involved in the . . . business, and the success achieved in that business are the factors which are to be considered by the courts in determining the reasonableness of the salaries received. (citations omitted) Other intangible factors reviewed by the courts include: (1) the officer's qualifications; (2) the nature, extent and scope of the officer's work; (3) the size and complexities of the business; (4) a comparison of salaries paid with the gross income and the net income; (5) the prevailing general economic conditions; (6) comparisons of salaries with distributions to stockholders; (7) the prevailing rates of compensation for comparable positions in comparable concerns; and (8) in the case of small corporations with a limited number of officers, the amount of compensation paid to a particular individual in previous years. (citations omitted) Since no single factor is dispositive, the determination of reasonableness is made on an individual basis in light of the facts and circumstances of the particular case involved.").

In considering the second question, the indirect benefit rule should be remembered. An example of the rule's application (although the court did not cite the rule) was the ruling in Complete Drywall that the debtor received fair consideration for its payments toward the principal's mortgage and home utility bills because the principal's residence was also used as a place of business for the debtor.

If the foregoing analysis shows that the employer did not receive reasonably equivalent value and the other criteria of § 548(a)(1)(B) are satisfied, then the payments can be avoided as fraudulent transfers. For the provider, the next issue is whether it must return the payments, which is decided pursuant to § 550(a).

### III. § 550(a)

#### a. Sources of Recovery and the Good-Faith Defense

Subsection 550(a) provides that to the extent a transfer is avoided under § 548,<sup>3</sup> it (or its value, if the court so orders) may be recovered from one of the following three sources:

1. "the initial transferee of such transfer";
2. "the entity for whose benefit such transfer was made"; or
3. "any immediate or mediate transferee of such initial transferee."

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<sup>3</sup> Transfers avoided under §§ 544, 545, 547, 549, 553(b) or 724(a) may also be recovered pursuant to § 550.

Subsection 550(b) provides, however, that the trustee may not recover from an “immediate and mediate” transferee if such transferee took “for value,” “in good faith,” and “without knowledge of the avoidability of the transfer avoided” (hereinafter, the “good faith defense”). The “immediate or mediate” transferees of the initial transferee are each of the transferees of the avoided transfer who are subsequent to the initial transferee, including, but not limited to, the transferee who is directly subsequent. See Bonded Financial Services, Inc. v. European American Bank, 838 F.2d 890, 896-97 (7<sup>th</sup> Cir. 1988).

The good faith defense is not available to initial transferees or entities for whose benefit the transfer was made; these parties face strict liability as to recovery of avoided transfers. See In re M. Blackburn Mitchell, Inc., 164 B.R. 117, 123 (Bankr.N.D.Cal. 1994)(“the Code makes knowledge or culpability on the part of the *initial* transferee irrelevant to whether the transferee will be liable for returning transferred property to the estate...the trustee may pursue recovery from successive transferees, but as soon as someone down the line takes for value, in good faith, or without knowledge of the voidability of the initial transfer, the Trustee’s ability to recover from that recipient is precluded.”). Therefore, under the Code’s terms, the provider faces strict liability for recovery of the avoided payments if it is adjudged an initial transferee or an entity for whose benefit the payments were made; it is irrelevant whether the provider knew that the payments were potentially avoidable.

A provider could not be considered “the entity for whose benefit such transfer was made,” because such an entity is ““someone who receives the benefit but not the money.”” In re Columbia Data Products, Inc., 892 F.2d 26, 29 (4<sup>th</sup> Cir. 1989)(quoting Bonded, 838 F.2d at 895). As set forth below, however, a provider will almost certainly be adjudged an initial transferee.

#### b. Initial Transferee Status

The Code does not define “initial transferee,” but that phrase has been defined in the reported cases as an entity who has legal dominion over the property that it receives, as well as the right to put the property to its own use. See, e.g., Bonded, 838 F.2d at 893; In re Southeast Hotel Properties Limited Partnership, 99 F.3d 151, 156 (4<sup>th</sup> Cir. 1996).

Bonded, which is the seminal case as to the definition of “initial transferee,” involved a debtor who had made a pre-petition transfer of \$200,000 to one of its principals in the form of a check made payable to the order of the principal’s bank. Id. at 891. The bank deposited the check into the principal’s account according to the debtor’s instructions. Id. At the time of the deposit, the principal owed the bank approximately \$655,000. Id. That debt was fully secured and not in arrears. Id. at 893. Ten days after the deposit, the principal instructed the bank to debit his account \$200,000 toward repayment of the \$655,000 debt. Id. at 891.

The bankruptcy trustee sued the bank to recover the \$200,000, arguing that the bank was the initial transferee. Id. The Seventh Circuit concluded that the bank was not the initial transferee because it had no right to put the \$200,000 it received from the debtor to its own use. Id. at 893. In this regard, the court stated that “[t]he bank acted as a financial intermediary. It received no benefit. [The principal’s] loan was fully secured and not in arrears, so the Bank did not even acquire a valuable right to offset its loan against the funds in [the principal’s] account.

Under the law of contracts, the Bank had to follow the instructions that came with the check. The Uniform Commercial Code treats such instructions as binding to the extent any contract binds. . . . [footnote omitted] The Bank therefore was no different from a courier or an intermediary on a wire transfer; it held the check only for the purpose of fulfilling an instruction to make the funds available to someone else.” Id.

The court concluded that “[a]lthough the Bankruptcy Code does not define ‘transferee’, and there is no legislative history on the point, we think the minimum requirement of status as a ‘transferee’ is dominion over the money or other asset, the right to put the money to one’s own purposes. When A gives a check to B as agent for C, then C is the ‘initial transferee’; the agent may be disregarded.” Id. at 893.

The Fourth Circuit adopted the Bonded analysis in Southeast Hotel Properties, stating that “we explicitly adopt the dominion and control test as set forth in Bonded.” 99 F.3d at 156. The court then held further that Bonded’s “dominion and control test” “requires that in order to constitute the ‘initial transferee’ of property under § 550(a) of the Bankruptcy Code, a person or entity must have exercised legal dominion and control over the property.” Id. In this regard, the court disagreed with the idea that “a party needs only physical dominion and control over the funds to constitute an ‘initial transferee. . . .’” Id.<sup>4</sup>

Some courts have essentially created an initial transferee so as to render true initial transferee a subsequent transferee, thereby allowing it to use the good-faith defense. The common thread in these cases is the degree of control exercised by a principal or officer of a debtor coupled with the impropriety of the transfer. See, e.g., In re Richmond Produce Co., Inc., 195 B.R. 455, 462 (Bankr.N.D.Cal. 1996)(emphasizing principal’s “complete dominion and control over” debtor-corporation of which he was sole shareholder, in terming him “initial transferee” of funds paid from debtor’s account to bank at which debtor maintained business accounts, for issuance of cashier’s check that was then tendered to creditor of principal); In re Auto-Pak, Inc., 73 B.R. 52, 54 (Bankr.D.D.C. 1987)(debtor’s principal “essentially took control of the funds” when he took debtor’s check made payable to IRS, had bank convert the debtor’s check to a cashier’s check payable to the IRS, and then used the check to pay tax obligation of an affiliated company – this rendered the principal an immediate transferee).

Most courts, however, have frowned upon manipulation of initial transferee status. See, e.g., Blackburn, 164 B.R. at 127 (“The court concludes that the mere fact that a debtor’s fraudulent transfer was directed by a principal of the debtor does not *ipso facto* transmute that principal into being the “initial transferee” within the meaning of §550. Reaching the contrary conclusion in order to protect an “innocent” of the transferred funds is contrary to policy consideration underlying the Bankruptcy Code.”).

c. Analysis

Based upon the definition of initial transferee set forth in Bonded and Southeast Hotel Properties, a provider is clearly an initial transferee of payments an employer makes on its

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<sup>4</sup> The United States Bankruptcy Court for the Eastern District of Virginia applied the analysis in Bonded and Southeast Hotel in In re Presidential Airways, Inc., 228 B.R. 594, 599-601 (E.D.Va. 1999).

employee's behalf. The provider obviously has the right to put the payments to its own use, as they are compensation for the goods or services the provider has given to the employee. The provider does not merely hold the payments as an intermediary or courier for someone else. Moreover, the provider probably can not escape "initial transferee" status through the creation of another initial transferee, as most courts have rejected such a tactic. As a result, the provider likely can not use the good-faith defense of § 550(b) and faces strict liability for recovery of the payments it has received.

#### IV. Conclusion

As the foregoing makes clear, a provider who accepts payments from an employer in exchange for a benefit provided to an employee does so at its peril. Such payments are subject to avoidance and recovery from the provider under §§ 548(a)(1)(B) and 550(a) if the employer ends up in bankruptcy. This may seem unfair and counterintuitive from the provider's perspective, as it will have received only what it is entitled to. Nonetheless, absent amendment of the Code, it is a reality that providers should bear in mind in structuring their affairs.