File No. 40166

IN THE SUPREME COURT OF CANADA
(ON APPEAL FROM THE COURT OF APPEAL FOR ONTARIO)

B E T W E E N :

JOHN AQUINO, 2304288 ONTARIO INC., MARCO CARUSO,
GIUSEPPE ANASTASIO a.k.a. Joe Ana AND LUCIA COCCIA a.k.a. Lucia Canderle

Appellants (Appellants)

- and -

ERNST & YOUNG INC., in its capacity as Court-Appointed Monitor
of Bondfield Construction Company Limited, and KSV KOFMAN INC., in its capacity as
Trustee-in-Bankruptcy of 1033803 Ontario Inc. and 1087507 Ontario Limited

Respondents (Respondents)

- and -

THE ATTORNEY GENERAL FOR ONTARIO and
INSOLVENCY INSTITUTE OF CANADA

Interveners

BOOK OF AUTHORITIES OF THE RESPONDENT
ERNST & YOUNG INC., IN ITS CAPACITY AS COURT APPOINTED MONITOR OF BONDFIELD CONSTRUCTION COMPANY LIMITED ON APPEAL
(Rule 44 of the *Rules of Supreme Court of Canada*)

VOLUME I

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TAB 1

there is no parsonage house; but the want of a parsonage house is no excuse for residing out of the parish entirely; and, therefore, there must be judgment for the plaintiff.

Aston and Willes Justices concurred.

Judgment for the plaintiff.

CADOGAN ET AL' *versus* KENNETT ESQ. ET AL'. Monday, May 6th, 1776. One being indebted, by settlement before marriage, in consideration of the marriage, and of 10,000l. his wife's portion, which was supposed to be more than the amount of his debts at that time; conveys all his real estate, and likewise his household goods (his real estate, alone not being thought an adequate settlement), in trust for himself for life, remainder to his wife for life, remainder to his first and other sons in strict settlement. The lady being a ward of Chancery, the settlement was approved of by the Master, and the goods enumerated in a schedule.—A. after the marriage, continued in possession of the goods; after which a creditor at the time of the settlement, having obtained judgment, took them in execution. Held, the settlement was good against creditors, and the trustees entitled to the possession of the goods. But if A. had let the house ready furnished, the defendant K. during A.'s life, would have been entitled to an apportionment of the rent. And there having been a sale of part of the goods in this case, it was by consent agreed, that the value should be vested in the funds, on the trusts of the settlement; and the interest during A.'s life paid the defendant K. The rest of the goods were ordered to be specially delivered.

[Referred to, *Jarman* v. *Woolloton*, 1790, 3 T. R. 622.]

Upon shewing cause why a new trial should not be granted in this case, Lord Mansfield reported as follows:

This was an action of trover brought by the plaintiffs, who are the trustees under the marriage settlement of Lord Montfort, against the defendant Mr. Kennett, who is a judgment creditor of Lord Montfort's, and the other defendants, who are sheriff's officers, to recover certain goods taken by them in execution under a fi. fa.—At the trial the plaintiffs proved Lord Montfort's marriage settlement, by which it appeared that the goods in question, which were the household goods belonging to Lord Montfort, at his lordship's house in town, and which were very minutely particularised in a schedule annexed to the settlement, were all conveyed to the plaintiffs, as trustees, for the use of Lord Montfort for life, remainder to Lady Montfort for her life, remainder to the first and other sons of the marriage in strict settlement.

One of the witnesses proved, that at the time of the settlement being made, it was known Lord Montfort was in debt:—but he thought the fortune of the lady he was to marry, which amounted to 10,000l. was amply sufficient to pay all the debts he owed at that time, and had no idea of disappointing any creditor. That Mr. Kennett was a creditor of Lord Montfort at the time of the settlement.—That Lady Montfort was a ward of the Court of Chancery; and the reason for including the household goods in the settlement was, because it was thought Lord Montfort's real estate was not of itself sufficient to make a proper and adequate settlement.—It appeared also that the settlement was referred to a Master in Chancery, who approved of the settlement, and the inserting the household goods for the reason above-mentioned.

[433] At the trial, I inclined to think, that the settlement being made under a treaty with the Court of Chancery, and approved of by the Master, was a bonâ fide transaction, and that the possession of Lord Montfort was not fraudulent, because it was in pursuance, and in execution, of the trust.

The jury found a verdict for the plaintiffs, damages 1s. and if the Court should be of opinion with the plaintiffs, then the goods were to be delivered specifically.

Mr. Wallace and Mr. Davenport, in support of the new trial, insisted that the settlement itself was a fraud, and the possession by Lord Montfort the strongest evidence possible of an intention to deceive creditors. That the fact of Lord Montfort's debts being made known to the trustees, was no ground for excepting this case out of the general rule: on the contrary, they ought in that case to have seen that Lord Montfort did not meddle with the fortune brought him by Lady Montfort; but should have had that sum invested in them for the purpose of discharging the debts due at that time. That this was the common case of a debtor making a beneficial trust for himself.—That Lord Montfort might have disposed of the goods during his lifetime; and consequently, as against him at least, they were not protected from an execution at the suit of a fair creditor. They compared this to the case of a trader selling his goods, continuing in possession, and afterwards becoming bankrupt; and cited 3 Co. 80, *Twine's case.*

Mr. Dunning contra, did not dispute the doctrine laid down in *Twine's case*, and admitted, that visible possession was a strong circumstance, in all cases, of fraud. But he insisted the possession in this case was not for any purpose of fraud but consistent with and agreeable to the trust. He agreed that Lord Montfort's interest was not protected, but contended the interest of Lady Montfort was protected: that the transaction was manifestly bonâ fide, and without the most distant intention to defraud, and therefore the plaintiffs were entitled to recover.

Lord Mansfield.—The question in this case is, whether the plaintiffs, who are trustees under the marriage settlement of Lord Montfort, by which the household goods in question are settled as heir looms with the house in strict settlement, and specifically enumerated in a schedule annexed to the settlement, so as to avoid any fraud by the addition or purchase of new; whether, the trustees are entitled to the possession of these goods against the defendant Mr. Kennett.

The defendant has taken the goods in execution; and it is not disputed that he is a fair creditor. But the plaintiffs bring this [434] action as trustees under the marriage settlement, and the question is, whether they are, against the defendant, entitled to the possession of these goods for the purposes of the trust.—I have thought much of this case since the trial, and in every light in which I have considered it, I have not been able to raise a doubt.

The principles and rules of the common law, as now universally known and understood, are so strong against fraud in every shape, that the common law would have attained every end proposed by the statutes 13 El. c. 5, and 27 El. c. 4. The former of these statutes relates to creditors only; the latter to purchasers. These statutes cannot receive too liberal a construction, or be too much extended in suppression of fraud.

The stat. 13 El. c. 5, which relates to frauds against creditors, directs "that no act whatever done to defraud a creditor or creditors shall be of any effect against such creditor or creditors." But then such a construction is not to be made in support of creditors as will make third persons sufferers. Therefore, the statute does not militate against any transaction bonâ fide, and where there is no imagination of fraud. And so is the common law. But if the transaction be not bonâ fide, the circumstance of its being done for a valuable consideration, will not alone take it out of the statute. I have known several cases where persons have given a fair and full price for goods, and where the possession was actually changed; yet being done for the purpose of defeating creditors, the transaction has been held fraudulent, and therefore void.

One case was, where there had been a decree in the Court of Chancery, and a sequestration. A person with knowledge of the decree, bought the house and goods belonging to the defendant, and gave a full price for them. The Court said, the purchase being with a manifest view to defeat the creditor, was fraudulent, and therefore, notwithstanding a valuable consideration, void.—So, if a man knows of a judgment and execution, and, with a view to defeat it, purchases the debtor's goods, it is void: because, the purpose is iniquitous. It is assisting one man to cheat another, which the law will never allow.—There are many things which are considered as circumstances of fraud. The statute says not a word about possession. But the law says, if after a sale of goods, the vendee continue in possession, and appear as the visible owner, it is evidence of fraud; because goods pass by delivery: but it is not so in the case of a lease, for that does not pass by delivery.

The stat. 27 El. c. 4, does not go to voluntary conveyances merely as voluntary, but to such as are fraudulent.* A fair voluntary conveyance may be good against creditors, notwith-[435]-standing its being voluntary. The circumstance of a man being indebted at the time of his making a voluntary conveyance, is an argument of fraud. The question, therefore, in every case is, whether the act done is a bonâ fide transaction, or whether it is a trick and contrivance to defeat creditors. If there be a

* Vide infra, 705, *Doe* v. *Routledge.*

conveyance to a trustee for the benefit of the debtor, it is fraudulent. The question then is, whether this settlement is of that sort. It is a settlement which is very common in great families. In wills of great estates, nothing is so frequent as devises of part of the personal estate to go as heir looms: * for in-[436]-stance, the devise of the Duke of Bridgewater's library.—The old Duke of Newcastle's plate. So in marriage settlements, it is very common for libraries and plate to be thus settled, and for chattels and leases to go along with the land. If the husband grows extravagant, there never was an idea that these could afterwards be overturned. If this Court were to determine they should, the parties would resort to Chancery.—We come then to the circumstances of the present case, which are very strong. There is not a suggestion of any intention to defraud, or the most distant view of disappointing any creditor. The very object of the marriage settlement was, that the lady's fortune might be applied to the discharge of all Lord Montfort's debts: the amount of this fortune was 10,000l. and was thought fully sufficient for that purpose. Besides this, it is a settlement approved by a Master in Chancery. Most clearly the Master in Chancery and the Great Seal could have no fraudulent view. But it appears further, that the reason why the goods were inserted was, because the settlement of the real estate alone was thought inadequate without them. Clearly, therefore, it was no

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* At the last sittings in Middlesex in Trinity term 1779, the following case arose upon the will of the late Lord Foley, and was tried before Lord Mansfield at Westminster. The name of it was *Foley and Another* against *Burnell and Another, Sheriffs of Middlesex.* It was an action of trover brought by the plaintiffs, who were trustees and executors under the late Lord Foley's will, against the defendants, to recover a certain quantity of wine, linen, and china taken by the defendants in execution, at the suit of a creditor of the present Lord Foley, the late Lord Foley's eldest son. Upon not guilty pleaded, the case at the trial appeared to be as follows: Thomas Lord Foley by will dated 19th June 1777, and by a codicil dated the 17th of September following, devised all his real estates in several counties to the plaintiffs for a term of 99 years, and subject thereto, to his eldest son Thomas Foley for life, with remainder to his first and other sons in strict settlement. Remainder to his second son Edward Foley for life, with remainder to his first and other sons in strict settlement. Remainder to Andrew Foley one of the plaintiffs, with remainder to his first and other sons in like manner; with remainders over. The trusts of the term were to receive the rents and profits, and thereout, according to their will and pleasure, to allow the two sons Thomas and Edward, yearly and every year, any sum or sums of money not exceeding in the whole the sum of 6000l. in any one year, till such time as the debts of his said two sons should be discharged; but so as his said two sons should have no estate or interest in the rents and profits of the said premises. And then the testator, after providing for the discharge of his said sons' debts, devised as follows: "Also I give and bequeath all the standards, fixtures, houshold goods, implements, and houshold furniture, pictures, tapestry, gold and silver plate, china, porcelaine, glass, statues, busts, libraries and books, which shall be in the said several capital messuages, called Stoke, Great Witley, and Foley House to be held and enjoyed by the several persons who from time to time shall successively and respectively be entitled to the use and possession of the same houses respectively, as and in the nature of heir looms, to be annexed to, and go along with, such houses respectively for ever."

At the death of the testator there was a considerable quantity of wine, linen, and china in Foley House.

The trustees under the will of Lord Foley, permitted his eldest son Lord Foley and his family to live in Foley House rent free; sent him the key of the wine, and Lady Foley the key of the linen and china: which they accordingly used as they liked, and continued in possession of, till they were taken in execution by the defendants in this action. Upon the execution's coming into the house, the plaintiffs gave notice to the sheriff that part of the wine, linen, and china, specifying the particulars of each, belonged to them as the trustees and executors under the late Lord Foley's will, and demanded them to be delivered up; which was refused.

The jury at the trial found a verdict for the plaintiffs, to the amount of the wine, linen, and china, taken in execution; and the defendants acquiesced without moving for a new trial.

contrivance to defeat creditors, but meant as a provision for the lady if she survived, and heir looms for the eldest son.

An argument, however, is drawn from the possession, as a strong circumstance of fraud: but it does not hold in this case. It is a part of the trust that the goods shall continue in the house; and for a very obvious reason: because, the furniture of one house will not suit another; and it was the business of the trustees to see the goods were not removed.

If Lord Montfort had let his house with the furniture, reserving one rent for the house, and another for the furniture; or if the rent could be apportioned, the creditors would be entitled to the rent; but they have no right to take the goods themselves: the possession of them belongs to the trustees, and the absolute property of them is now vested in the eldest son.

I expected an authority; but though such settlements are frequent, no case has been cited to shew they are fraudulent. How common are settlements of chattels, and money in the stocks: can there be a doubt but they are good? Yet the creditors would be entitled to the dividends during the interest of the debtor. Here, there was clearly no intention to defraud, and there is a good consideration. Therefore, I am of opinion it could not be left to the jury to find the settlement fraudulent, merely because [437] there were creditors. The goods must now be kept in the house for the benefit of the son.

Aston Justice. I am of the same opinion.

Willes Justice.—I am of the same opinion.

Per Cur. Rule for a new trial discharged.

Lord Mansfield.—The goods and furniture that have not been sold are to be delivered specifically. As to those which have been sold, let any indifferent person put a value upon them; the value to be paid by Mr. Kennett, and the amount vested in Government securities at 3l. per cent. upon the trusts of the settlement; the interest to be paid to Alderman Kennett during Lord Montfort's life. And as to all the goods which are not included in the schedule, they belong to the defendant under the execution.

N.B. This was consented to at Nisi Prius, in case the Court should be with the plaintiffs upon the general question.

MARTYN *versus* HIND. Friday, May 17th, 1776. If a rector give A. B. a title to the bishop and thereby appoint him curate of his church, promising to allow him a salary and to continue him in the office of curate, till otherwise provided of some ecclesiastical preferment, unless lawfully removed for any fault, he cannot afterwards remove him without cause: and if the salary be in arrear, A. B. may maintain assumpsit upon the title.—A readership is not an ecclesiastical preferment within the meaning of such title.

Upon shewing cause why a new trial should not be granted, the case as it appeared by the report was to this effect. The action was an action brought by the plaintiff against the defendant, who was the rector of St. Ann's Westminster, to recover a sum of money due from him to the plaintiff, for officiating as his curate. The declaration consisted of several counts. The third count, on which the verdict was taken, stated as follows: "And whereas also the said Richard at the time of the making the promise and undertaking hereinafter next mentioned, was, and from thence always hitherto hath been, and still is, rector of the said parish church of St. Ann Westminster in the said county, to wit, at Westminster in the said county, and the said Richard being such rector as aforesaid, by a certain instrument in writing, subscribed by and with the proper hand of the said Richard, bearing date the 13th of February 1769, at Westminster aforesaid, he the said Richard undertook, and to the said Thomas then and there faithfully promised to retain, and continue the said Thomas to officiate in the said church, until he should be otherwise provided with some ecclesiastical preferment, unless, by fault by him committed, he the said Thomas should be lawfully removed from the same; and to pay him the sum of fifty guineas a year during that time. And the said Thomas in fact says, that although he is not yet provided with any other ecclesiastical preferment, nor has been lawfully removed from the same church, or [438] officiating therein, yet the said Richard, not regarding, &c."—Plea non assumpsit. Verdict for the plaintiff. At the trial, the plaintiff, in order to prove

TAB 2

Dickinson v NAL Realisations (Staffordshire) Ltd and others

[2017] EWHC 28 (Ch)

CHANCERY DIVISION (AT BIRMINGHAM)

JUDGE DAVID COOKE

13, 14, 17–21 OCTOBER 2016, 16 JANUARY 2017

Transactions at undervalue – Transactions defrauding creditors – Transaction designed to defeat claims of creditors – Company facing nuisance claim by residents for odour emanating from aluminium smelting foundry – Main shareholder taking steps to put company's assets beyond reach of environmental claimants – Sale and transfer of foundry premises to main shareholder at less than 40% of book value – Share buy-back scheme – Sale of subsidiary to main shareholder for £1 – Whether transactions defrauding creditors – Whether transactions void – Whether main shareholder acting in breach of duty – Whether main shareholder entitled to be relieved of liability – Insolvency Act 1986, s 423 – Companies Act 2006, ss 172(3), 191, 691(2), 1157.

In 2000 D acquired a company which owned and operated an aluminium smelting foundry in Staffordshire and became the managing director and controlling shareholder. He transferred 39.2% of the shares to a discretionary settlement and 10.2% to his pension fund. His wife became a director in 2002 and an employee, W, was made a director in 2008. In 2005 the company transferred the freehold foundry premises to D for £224,000, which was less than 40% of the book value of the land and buildings. D leased the premises back to the company for £40,000 pa. In 2006 the company established a subsidiary in India funded by share capital provided out of D's loan account with the company and by secured loans of £1.4m. In the same year D became aware that a firm of solicitors was attempting to organise a group legal action by local residents (the environmental claimants) to claim damages in nuisance against the company for odour, dust and noise pollution from the foundry. In March 2007 the company received a letter of claim from the solicitors. In February 2010 the company sold a subsidiary, Norse, to D for £1 and in June 2010 D arranged for the company to buy back 2.5m shares at the nominal value of £2.5m, the purchase price being provided by a shareholder's loan secured by a debenture over the company's assets. In May 2012 the nuisance claim went to trial and in August the judge hearing the claim circulated a draft judgment in which he upheld the claims for nuisance caused by odour and indicated that he proposed to award damages to the lead environmental claimants of some £160,000, which when extrapolated to other claimants was going to result in the company being liable for total damages of about £1.2m plus costs of some £2m. In September 2012 the company went into administration and the administrators arranged a prepack sale of the company's assets to D for £500,000. D brought proceedings against the liquidators to recover a £1m debt which he claimed was owed to him and was secured by the debenture over the company's assets. The liquidators counterclaimed in which they sought to avoid (i) the transfer of the foundry premises to D for £224,000 in 2005, on the grounds that it was not authorised by the directors and shareholders, (ii) the sale of the Norse subsidiary to D for £1 and the share buy-back, because they were transactions at an undervalue intended to put assets beyond the reach of creditors, and (iii) further investments and loans and supplies on credit amounting to some £750,000 made by the company to the Indian subsidiary, and the issue of shares in the subsidiary to D, which had been paid for by the company on his behalf by debiting his loan account.

Held – (1) The sale and transfer of the foundry premises to D in 2005, the share buy-back in 2010, and the sale of the Norse subsidiary to D for £1 were all voidable because they were part of D's overall scheme to move assets out of the company so that they would not be available to the environmental claimants if their claim succeeded. In each case D's actions were effectively the actions of all of the shareholders, but he had no authority to act on their behalf and the sale or transfer was not authorised or ratified by either the unanimous approval or acquiescence of the shareholders or the directors, since there had been no meetings of the directors or if there had been, there had been no quorum because D was not entitled to vote on the resolution or to be counted in the quorum and his wife, who was the only other director at the time, could not have passed the resolution herself, even had she been present, and moreover the sale was not authorised or ratified by, or even brought to the attention of, the trustees of the pension fund. (See paras [69]–[74], [82], [89], [105], [123]–[127], [150], below.) *Re Duomatic Ltd* [1969] 1 All ER 161 distinguished.

(2) The sale and transfer of the foundry premises to D was also void because there was no indication of what benefit the company obtained from the sale, there was no reason why it was in the company's interests to sell the premises and then pay rent, and no independent valuation had been obtained to support the price paid. If D had acted honestly and reasonably in the interest of the company rather than himself he would have obtained a professional valuation to support the price being paid. D therefore held the foundry premises on trust for the company and was liable to restore the property to the company and to pay compensation of £415,000, being the amount of rent paid or credited to him. (See paras [77]–[81], below.)

(3) The share buy-back scheme was void because the shares had not been 'paid for on purchase' as required by s 691(2) of the Companies Act 2006 and had instead been left outstanding as a secured shareholder's loan even though D had no authority to make any loan agreement, orally or in writing, on behalf of the pension trustees, and could not validly commit the company to take a loan in a matter in which he was interested without a resolution of shareholders, which was not obtained (and their approval could not be taken to have been given informally) or a valid resolution of the directors. Recognition of the debt by making an entry in the books of account did not constitute payment but was merely an acknowledgment of the legal consequences of non-payment. Moreover, D's dominant intention in arranging the share buy-back was to convert the rights of shareholders

into claims for secured debt both to prejudice the interests of the environmental claimants by increasing the pool of liabilities competing with their claim and to put assets beyond their reach by ensuring that the shareholders' debt had a prior claim on the assets. To the extent the company participated in the share buy-back transaction it did so because of the decisions and actions of D, and his purposes were to be considered as being the purposes of the company. The share buy-back scheme was therefore a transaction entered into to defraud creditors for the purposes of s 423 of the Insolvency Act 1986 and since the buy-back, loan and security arrangements were to be regarded as one transaction for the purposes of s 423, when that transaction was set aside the security provided by the debenture and D's claims founded on it fell with it and such claims as he had against the company were those of an unsecured creditor. (See paras [90]–[93], [96]–[97], [111]–[112], [168], below.) *BDG Roof-Bond Ltd v Douglas* [2000] 1 BCLC 401 and *BTI 2014 LLC v Sequana SA, BAT Industries plc v Sequana SA* [2016] EWHC 1686 (Ch), [2017] 1 BCLC 453 considered.

(4) However, in causing the company to enter into the share buy-back D had not acted in breach of duty, because the general duties of directors did not require them to give priority to the interests of creditors simply because there was a recognised risk of adverse events that would lead to insolvency. At the time the buy-back was entered into, it did not place the company on the verge of insolvency and therefore the directors' duty under s 172(3) of the Companies Act 2006 to have regard to the interests of creditors did not arise. (See paras [118]–[121], below.) *Hellard v Carvalho, Re HLC Environmental Projects Ltd* [2013] EWHC 2876 (Ch) and *BTI 2014 LLC v Sequana SA, BAT Industries plc v Sequana SA* [2016] EWHC 1686 (Ch), [2017] 1 BCLC 453 considered.

(5) The transfer of shares in Norse to D was void because he had no implied or informal authority to make the sale to himself and there was no subsequent action, or even sufficient knowledge of the terms of the sale coupled with inaction, from which ratification or acquiescence by the board sufficient to amount to approval could be inferred. The shares constituted a 'substantial non cash asset' for the purposes of s 191 of the Companies Act 2006 and in the absence of approval by resolution of the members the sale was voidable. The sale was also a transaction at an undervalue which was caught by s 423 of the Insolvency Act 1986. D had acted in breach of his fiduciary duty in preferring his own interests over those of the company by transferring an asset worth £214,000 to himself for £1. D would therefore be ordered to return the Norse shares to the liquidators or pay an amount equal to their value at the date of administration. (See paras [127]–[128], [145], [148]–[153], below.)

(6) D was not entitled to be relieved of liability pursuant to s 1157 of the Companies Act 2006 on the ground that he had 'acted honestly and reasonably', since he had not sought to act in the best interests of, or even with any proper regard to the interests of, the company as distinct from himself and had instead acted in his own interest to protect his wealth against the possibility of an adverse judgment. (See paras [76], [81], [154]–[155], below.)

(7) Since all substantive decisions in the company's affairs were taken by D alone, the other directors, his wife and W, were not liable for any loss to

the company, since the wife had played no part in the decisions and the directors' breach of duty in failing to engage in any responsibility for the company's affairs had not caused any loss to the company. (See paras [83], [160]–[161], below.)

(8) Since it was not per se a breach of duty to invest in a minority shareholding or to make loans to a company in which the lender had minority holding, the purchase of shares in the Indian subsidiary did not amount to a 'preference' of the interests of D as another shareholder and could not be said to be an uncommercial investment. The liquidators' counterclaims relating to the Indian subsidiary therefore failed. (See paras [166]–[167], below.)

Cases referred to

Ailyan and Fry (Trustees in bankruptcy of Kevin Foster) v Smith [2010] EWHC 24 (Ch), [2010] BPIR 289.

Alcoa Minerals of Jamaica Inc v Broderick [2002] 1 AC 371, [2000] 3 WLR 23, 56 WIR 433, PC.

Anslow v Norton Aluminium Ltd [2012] EWHC 2610 (QB), [2013] All ER (D) 03 (Jan).

Bacon (M C) Ltd, Re (No 2) [1990] BCLC 607, [1991] Ch 127, [1990] 3 WLR 646.

Barings plc, Re (No 5), Secretary of State for Trade and Industry v Baker (No 5) [1999] 1 BCLC 433, Ch D; *affd* [2000] 1 BCLC 523, CA.

Barr v Biffa Waste Services Ltd [2011] EWHC 1003 (TCC), [2011] 4 All ER 1065, 137 ConLR 125, QBD; *rvsd* [2012] EWCA Civ 312, [2012] 3 All ER 380, [2013] QB 455, [2012] 3 WLR 795,141 ConLR 1, CA.

BDG Roof-Bond Ltd v Douglas [2000] 1 BCLC 401.

Brady v Brady [1988] BCLC 20, CA; *rvsd* [1988] BCLC 579, [1988] 2 All ER 617, [1989] AC 755, [1988] 2 WLR 1308, HL.

BTI 2014 LLC v Sequana SA, BAT Industries plc v Sequana SA [2016] EWHC 1686 (Ch), [2017] 1 BCLC 453.

Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd, Eaton Bray Ltd v Palmer [2002] EWHC 2748 (Ch), [2003] 2 BCLC 153.

Customs and Excise Comrs v West Yorkshire Independent Hospital (Contract Services) Ltd [1988] STC 443.

Duomatic Ltd, Re [1969] 1 All ER 161, [1969] 2 Ch 365, [1996] 2 WLR 114.

Facia Footwear Ltd (in administration) v Hinchcliffe [1998] 1 BCLC 218.

GHLM Trading Ltd v Maroo [2012] EWHC 61 (Ch), [2012] 2 BCLC 369.

Gidman v Barron [2003] EWHC 153 (Ch), [2003] All ER (D) 182 (Feb).

Hellard v Carvalho, Re HLC Environmental Projects Ltd (in liq) [2013] EWHC 2876 (Ch), [2014] BCC 337, 37 CSRC 16/1, [2013] All ER (D) 240 (Sep).

IRC v Hashmi [2002] EWCA Civ 981, [2002] 2 BCLC 489.

Kalls Enterprises Pty Ltd v Baloglow [2007] NSWCA 191, 25 ACLC 1094, NSW CA.

Kinsela v Russell Kinsela Pty Ltd (in liq) (1986) 4 NSWLR 722, 4 ACLC 215, 10 ACLR 395, NSW CA.

Lexi Holdings plc (*in administration*) *v Luqman* (*No 1*) [2007] EWHC 2652 (Ch), [2007] All ER (D) 265 (Nov).

Lexi Holdings plc v Luqman (*No 2*) [2008] EWHC 1639 (Ch), [2008] 2 BCLC 725; *rvsd* [2009] EWCA Civ 117, [2009] 2 BCLC 1.

Lonrho Ltd v Shell Petroleum Co Ltd [1980] 1 WLR 627, HL.

Madoff Securities International Ltd (*in liq*) *v Raven* [2013] EWHC 3147 (Comm), [2013] All ER (D) 216 (Oct).

Neville v Krikorian [2006] EWCA Civ 943, [2007] 1 BCLC 1.

Roberts v Frohlich [2011] EWHC 257 (Ch), [2011] 2 BCLC 625.

Thoars (*decd*), *Re* (*No 2*), *Ramlort v Reid* [2004] EWCA Civ 800, [2005] 1 BCLC 331, [2004] BPIR 985.

Ultraframe (*UK*) *Ltd v Fielding* [2005] EWHC 1638 (Ch), [2007] WTLR 835, [2006] FSR 293, [2005] All ER (D) 397 (Jul).

Walker v Stones [2000] 4 All ER 412, [2001] QB 902, [2001] 2 WLR 623, CA.

West Mercia Safetywear Ltd v Dodd [1988] BCLC 250, CA.

Westmid Packing Services Ltd, Re, Secretary of State for Trade and Industry v Griffiths [1998] 2 BCLC 646, [1998] 2 All ER 124, CA.

Action and counterclaims

The claimant, Henry George Dickinson, brought a claim to recover in the liquidation of the first defendant, NAL Realisations (Staffordshire) Ltd, various sums totalling over £1m which he alleged were due to him and secured by a debenture over the company's assets. By various counterclaims the joint liquidators of the company, Kevin John Hellard and Gerald Krasner, sought to avoid certain transactions carried out by the claimant while managing director and majority shareholder of the company. The two other directors of the company, Judith Yap Dickinson and Robert Williamson, were joined as third and fourth parties. The facts are set out in the judgment.

James Morgan (instructed by *Francis, Wilks & Jones*) for the claimant and the third and fourth parties.

James Barker (instructed by *Gateley plc*) for the defendants.

Judgment was reserved.

16 January 2017. The following judgment was delivered.

JUDGE DAVID COOKE.

INTRODUCTION

[**1**] This case concerns a company called at the material times Norton Aluminium Ltd, which operated an aluminium smelting foundry in Norton Canes in Staffordshire. That company (which I will refer to as 'the company' or 'Norton Aluminium') went into administration in August 2012 following the circulation of a draft judgment by which Judge McKenna, sitting as a judge of the Queen's Bench Division in this court, upheld in part claims in nuisance brought against it by a group of local residents. It is now in liquidation and is the first defendant in this claim.

Mr Dickinson, who was the managing director and controlling shareholder of the company, originally brought the claim to recover in the liquidation various sums totalling (for present purposes) just over £1m which he says are due to him and secured by a debenture over the company's assets.

[2] The liquidators bring various counterclaims against Mr Dickinson and claims against the third and fourth parties who were directors of the company, in which—

(i) they seek to avoid a transfer of the company's factory premises to Mr Dickinson made in 2005, on the basis that it was not properly authorised by the directors and shareholders at that time, and

(ii) they seek, on various grounds, to set aside or recover compensation for transactions entered into in 2010 and thereafter in which—

> (a) the company bought back most of its shares from Mr Dickinson and connected parties for £2.5m, which was left outstanding as a secured loan,
>
> (b) the company sold a subsidiary (Norse Castings Ltd or 'Norse') to Mr Dickinson for £1, which is alleged to be an undervalue, and
>
> (c) the company made further investments in and loans and supplies on credit to a related company in India, notwithstanding that Mr Dickinson had arranged that shares in that company be issued to him (paid for out of the proceeds of the share buy-back) such that he became the majority shareholder.

These transactions, it is said, formed a scheme by which Mr Dickinson restructured the affairs of the company when it was threatened with the litigation that eventually brought it down with the object that the claimants in that litigation would receive nothing if they won and he would be in a position to buy the main business from an administrator and continue it under a 'phoenix' company, as indeed he eventually did.

I refer to the bases on which these transactions are attacked in more detail below, but for present purposes it is sufficient to say that the liquidators allege that the directors were in breach of duty to consider the interests of creditors, which they say were engaged at the material times, as well as those of shareholders, that Mr Dickinson in particular preferred his own interests over those of the company, that the share buy-back and sale of Norse were transactions at an undervalue intended to put assets beyond the reach of creditors within s 423 of the Insolvency Act 1986 and/or were void, alternatively voidable, by reason of lack of proper authorisation by directors and/or shareholders and/or failure to comply with formalities required by the Companies Act 2006.

[3] As against Mrs Dickinson and Mr Williamson, the claims against them are, again broadly, of breach of duty in that they either participated in the transactions challenged and so were guilty of the same breaches as are alleged against Mr Dickinson, or they improperly abdicated their responsibilities as directors by allowing Mr Dickinson to run the company as he saw fit and enter into these transactions without consultation with them. Mr Williamson is not involved in the 2005 property transfer as he was not a director at the time. Both these parties say that, insofar as they allowed Mr Dickinson to take decisions, that was appropriate delegation by them. If they are found in breach of duty they seek relief under s 1157 of the Companies Act 2006 on the basis that they acted honestly and

reasonably and ought fairly to be excused.

[4] It is convenient to set out the chronology in more detail at this point before turning to the individual claims.

THE FACTUAL BACKGROUND

[5] The foundry business has been operating on the site at Norton Canes for over 50 years. Mr Dickinson acquired the entire share capital of the company which owned and operated it in 2000. It appears that he transferred some shares soon afterwards to the trustees of the STB Engineering Ltd Directors SSAS (Small Self Administered Scheme, 'the pension scheme'). According to a definitive trust deed prepared in 2007 the pension trustees were Mr Dickinson and Mrs Dickinson together with Barnett Waddingham Trustees Ltd which was appointed, as required by statute, as the scheme's professional trustee. Since there are issues about whether transactions were approved or ratified by the holders of the shares owned by the pension scheme, I note that although I was not shown the register of shareholders the company's annual returns record the pension scheme itself as being the shareholder, and I proceed on the basis that the registered member is either named as being the pension scheme, or that all the trustees are registered as joint holders. Mr Dickinson did not make any case that he was the sole registered holder and so, as against the company, entitled to do any act of the member holding such shares.

[6] Other shares appear to have been transferred to the trustees of the H Dickinson Discretionary Settlement 2003 ('the settlement'), which was created by Mr Dickinson. Again the company's annual returns show the settlement itself as being the shareholder. Although the liquidators' assumption (and my own) throughout the trial was that Mrs Dickinson was also a trustee of the settlement, Mr Morgan submitted in closing that this was not actually established by the evidence, and Mr Barker made the concession that he would accept that Mr Dickinson was able to act on behalf of the settlement as if he had the authority of any other trustee.

[7] According to the annual returns, at all material times Mr Dickinson has held 50.6% of the issued ordinary shares, the pension scheme 10.2% and the settlement 39.2%. Mrs Dickinson became a director in 2002. Mr Williamson was appointed a director on 1 January 2008. The company secretary throughout was Mr Lynn Tranter, who made a witness statement on behalf of Mr Dickinson and attended to give evidence but was taken ill in the witness box before Mr Barker could complete his cross-examination. Fortunately he recovered, but Mr Barker in the circumstances did not ask that he be recalled. The company's auditors were Mercer & Hole.

[8] In September 2005 the freehold factory premises from which the company traded were transferred by it to Mr Dickinson. A board minute was produced recording a meeting between Mr and Mrs Dickinson as directors and Mr Tranter as company secretary in which the directors resolved that the company should sell the freehold to Mr Dickinson for £224,000 and take a lease back for a period of four years at a rent of £40,000 per annum, contracted out of the security of tenure provisions of the 1954 Landlord and Tenant Act. Mr Tranter is reported as expressing concern that the purchase price may be below market value, although Mr Dickinson disagreed. According to the minute, 'The price offered also reflected the below-market rate of rent. He [Mr Dickinson] also undertook to enter into a new lease on similar terms at the end of the four-year period, if circumstances reasonably permitted'. This is the first of the transactions challenged. At some point in 2010, Mr Dickinson transferred the property into the joint names of himself and his wife.

[9] In 2006 Mr Dickinson began investigating the possibility of establishing a subsidiary company to carry on a similar business situated in India. He considered that there was a good potential market in India for metal in ingot form and that it would be advantageous to smelt the metal in India from scrap supplied from the UK because scrap could be imported tariff free but finished ingots would attract a substantial customs duty. Norton Aluminium India Pte Ltd ('NAI' or 'Norton India') was incorporated in India in September 2006 as a wholly-owned subsidiary of the company. It acquired land and equipment in order to establish a foundry in India. In order to comply with Indian exchange control regulations, NAI was funded by a combination of share capital and secured loans, which eventually totalled £1.4m, made pursuant to a term loan agreement for which consent had to be obtained from the Reserve Bank of India. In addition, scrap was supplied to NAI from the parent company in the UK on credit terms. Mr Dickinson's evidence was that it would not have been possible simply to lend money on an unsecured on demand basis, since that would have been regarded by the Indian authorities as a method of extracting profit and avoiding exchange control.

[10] In November 2006 Mr Dickinson became aware that letters had been circulated to a number of local residents by Hugh James, a firm of solicitors in which they said they were investigating the possibility of 'pursuing a group legal action against the operators of the Norton Aluminium site claiming compensation for odour, dust and noise pollution as well as an injunction to stop the defendant from continuing the nuisance in the future'. It referred to their specialism in environmental group actions and said: 'We have successfully handled a number of high-profile cases over the years throughout the UK on a "no win no fee" basis …' Mr Tranter sent a copy of this letter to the company's insurance brokers, asking for confirmation that any claim would be covered by insurance.

[11] Hugh James sent a letter of claim dated 14 March 2007 in which they said they acted for 27 potential claimants seeking to pursue a claim for an injunction and damages for nuisance caused by odours, dust and noise. The letter said that the solicitors were of the view that the litigation should be conducted under a group litigation order ('GLO') and that they were acting the terms of a conditional fee agreement, and invited an admission of liability.

[12] The next relevant document in the bundle is a letter sent by Hugh James dated 8 January 2008 to Weightmans solicitors. According to Mr Dickinson, very little had happened to progress the potential claim in the interim, but it appears that since their letter of claim the previous year Hugh James must have been in correspondence at least with Cunningham Lindsay (a firm of loss adjusters presumably instructed by the company's insurers) and Weightmans, who up to that point had been instructed by the insurers. It is apparent from Hugh James's letter that there had been a denial of liability and some discussion about a GLO. At about the time of receipt of this letter however the insurers must have denied liability under the policy, which they did on the basis that claims for pollution were not covered unless caused by a sudden unexpected event. Thereafter, Weightmans were instructed direct by the company.

[13] On 8 February 2008 Mr Cottam, a partner in Weightmans, wrote to Mr Dickinson to record that he would now be acting directly for the company. He referred to having previously carried out liability investigations and to an attendance note dealing with that aspect, although that has not been included in the bundle. Mr Cottam says in that letter that he will need to instruct counsel to prepare a defence. He does not say anything directly about his view of the potential merits of the claim, but his letter includes the following:

> 'It is very difficult to estimate, with any degree of accuracy, the likely costs in this case. So far as your legal costs are concerned, your insurers have settled those costs to date …
>
> The claimant's solicitors are seeking a Group Litigation Order. These are a notoriously costly way of litigating. If the case were to proceed to a final trial, it is not inconceivable that the claimants' solicitors costs will exceed any damages. For reserve purposes only I would suggest that you allow the following:

Damages	£150,000
Legal costs	£150,000
	£300,000

> I have not arrived at the above figures by any precise calculation. I understand there are about 100 claimants and I have allowed £1500 damages for each claimant. That is how I arrive at the figure of £150,000. Legal costs is my best estimate at this stage.
>
> Obviously I will keep the valuation of this claim under close consideration and will advise you if the figure increases or decreases for whatever reason.'

[14] On 3 June 2008, Ms Dale, an assistant solicitor at Weightmans who by now was dealing with the case, forwarded two letters received from Hugh James. One of these was a without prejudice letter, and in relation to that Ms Dale said:

> 'It indicates that the 98 claimants are anticipated to claim £2000 each for each year that they have suffered a nuisance.
>
> That amounts to in excess of £1.2 million. Further, the claimants will be asking the court for an injunction to prevent the nuisance continuing.
>
> At this stage … we should now formally instruct counsel to prepare an advice …
>
> *Costs and Potential Exposure*
>
> Dave Cottam provided you with a costs estimate in his letter of 8 February 2008. At that stage he indicated that £150,000 was his best estimate of the claimant's legal costs. This was based on a guesstimated damages claim of also £150,000 …
>
> Since Dave's letter to you we have received Hugh James' letters which indicate that the claim against your company is in excess of £1.2 million in relation to past nuisance. You will appreciate therefore that this in turn will increase the legal costs involved …

> If all 98 (or however many claims are finally brought) claims are tried together under a Group Litigation Order, the likely costs of this litigation will be high. My best estimate of them is somewhere between £300,000-£450,000, plus VAT and disbursements.
>
> I have no reason to believe that the claimants' costs would vary greatly from your own. However because the claimants' solicitors are acting under a CFA, they are entitled to claim from your company up to 100% extra by way of uplift … As a result, the costs payable by your company if you lose the litigation could easily amount to £1.35 million …
>
> I advise that your potential exposure could be as much as £2.55 million. This of course is the worst case scenario if you were to lose …
>
> I appreciate that the figures above may be quite startling, however it is important that we provide you with the best estimate we can, at this early stage, in terms of the legal costs.'

[15] Mr Dickinson obviously objected strongly to the anticipated level of Weightmans' fees. Ms Dale wrote a further letter dated 15 July 2008, responding to an email which is not in the bundle, explaining why the fees she had estimated were considerably higher than the figures originally given by Mr Cottam. She also said:

> 'It is my professional obligation to give you my best estimate of the likely costs of this matter. I understand that you do not like the estimate that I have provided. I also understand that you do not intend to spend £450,000 plus VAT plus disbursements in defending this matter. That is your prerogative. However it does not change either my professional obligations or my cost estimate of £450,000 per party … In addition, the success fee which is applicable to the claimants' costs means that a further £450,000 plus VAT, plus disbursements needs to be included in your exposure.'

Shortly after that, Mr Dickinson withdrew Weightmans' instructions. From then until December 2009, a period of just under 18 months, he dealt with correspondence himself.

[16] Before me Mr Dickinson maintained that he at all times considered the likely maximum exposure for damages and costs if the claim was lost to be the £300,000 originally estimated by Mr Cottam, and that this estimate by a partner was more reliable than the subsequent figures, seeking to dismiss Ms Dale's letter as being sent by an assistant solicitor seeking to justify excessive fees. This would not have been a reasonable view of Ms Dale's letter, which makes clear it was written after discussion with Mr Cottam and the partner then in charge. Nor do I accept this was what Mr Dickinson in fact thought of it at the time. He did not wish to spend anything like the amounts estimated for his own costs, but I do not believe he thought either that the risk of a costs claim by the other side was limited to Mr Cottam's figure, or that if he used solicitors to defend the claim his own costs would be similarly limited.

[17] In a letter to the auditors dated 5 February 2009 Mr Dickinson proposed making a provision in the accounts of £100,000 in respect of the nuisance claim. He sent the auditor copies of various solicitors letters—

> 'to substantiate the provision. You will see that the lawyers advise the total cost to us, if we lose, could be £1.35m. Would a much larger provision therefore be tax allowable?'

Mr Dickinson accepted that this figure had come from Ms Dale's letter, and that he knew the advice had in fact been that the total exposure could be £2.55m, including damages.

[**18**] On 22 June 2009 Hugh James wrote acknowledging that there had been some delay, but stating that they proposed to proceed with an application for a GLO. Mr Dickinson responded with a long list of questions seeking details of the claim, which he said he had taken from an earlier letter written by Weightmans. Hugh James repeated their inquiry on 7 October, and Mr Dickinson repeated his response on 12 October 2009.

[**19**] From this point onwards, the liquidators say, Mr Dickinson began to develop his plan to protect assets against the risk of losing the claim. On 15 October 2009 Mr Tranter wrote to a tax partner at the auditors saying:

> '**Capital reduction**
>
> Henry wants to re-examine a capital reduction at Norton with the company purchasing its shares back from Henry … Henry's thought was to loan the money back to Norton with a charge over the assets – second to HSBC. Loan would be interest-bearing …
>
> **NA India**
>
> Henry also wishes to explore the removal of NA India from a wholly owned subsidiary of Norton Aluminium …'

There had been previous discussion of a share buy-back from 2003, but it had not been progressed and does not appear to have been under active consideration for some years.

[**20**] On 30 November 2009 Hugh James wrote again sending a draft of their application for a GLO, which they stated would be filed at court on 17 December 2009. They asked to be informed which solicitors the company would instruct, and it seems that this prompted Mr Dickinson to instruct Carter Lemon Camerons LLP ('CLC'), a firm that had previously acted for the company in unrelated matters. CLC wrote to Hugh James on 10 December 2009 indicating that the GLO would be opposed, and simultaneously to the company's insurers and the loss adjusters, seeking to reopen the question of coverage. That was promptly rebutted.

[**21**] On 5 January 2010, Mr Dickinson sent an email to the tax partner saying:

> 'Want to quickly run an idea past you:
>
> I am considering selling 51% of the shares in Norton India to my mother at par and/or inviting her to subscribe to new shares to achieve the same result.
>
> Rationale being fourfold:
>
> Holding should be IHT exempt after two years …
>
> As a 49% subsidiary Norton UK would not have to consolidate India's balance sheet with our own …
>
> As a minority shareholder, Norton UK or any receiver appointed, would be unable to force the sale of Norton India or otherwise wrest

> control of Norton India. Indeed a subscription agreement could require a
> a receiver to sell its stake in Norton India on pre-agreed terms to the other shareholders.
>
> Norton India would not be considered under common control for the purposes of small-company tax bands or grant eligibility.'

[22] On 4 January 2010 Hugh James wrote stating that they intended to b
proceed with the application for a GLO. Two days later Mr Dickinson wrote to CLC saying that the company had 'an expert already providing us with advice and opinions'. He made the point, which he has strongly maintained throughout, that the company's business had planning permission for its operations and had to comply with licence conditions for its operation and emissions, but had not been subject to any action from its c
regulator except on one occasion in respect of an isolated incident. Residents, he said, must expect to see hear and smell some evidence of these operations, but it was the regulator's role to set and monitor conditions so as to ensure that no unreasonable nuisance was caused. He concluded:

> 'I am not sure how relevant this all is to fighting the GLO. In order to d
> constrain costs (and until we pin the matter on [insurers]) I think we should limit ourselves to opposing the GLO at this juncture … Presumably the merit or otherwise of their claim will not be substantially tested in the GLO application?'

[23] On 11 January 2010 CLC wrote to say that they had held an initial e
discussion with counsel who had been involved in a recent similar case brought by Hugh James on behalf of a large number of local residents complaining of nuisance: 'We know from the papers that Hugh James have been involved in over 10 other GLO's. It seems that Hugh James have a history of generating such cases.' The advice was that the application for a GLO should be opposed and 'there is at least an arguable case – probably f
50–50 – that your opposition will succeed' but nevertheless counsel had advised 'in the majority of cases it is difficult to persuade a court not to make a GLO'.

[24] The letter went on to say:

> 'It is likely that to defend the GLO application we shall argue … g
> Secondly, on a brief review of the merits (a court will not consider the merits of the claim in detail at this stage) the claimants' claims are weak and unsubstantiated.'

There was reference to applying to the court for a cost-capping order 'to prevent the claimants potentially running up huge legal costs which if the h
claim is successful (even if only partly so) may potentially be payable by you.' It pointed out that compliance with regulation was not a bar to a claim in nuisance, though it said it may be relevant in deciding whether the behaviour complained of is sufficient to amount to a nuisance, and said:

> 'counsel is confident … that at a full trial a court is unlikely to grant i
> an injunction in circumstances where the factory is compliant with statute and the terms of the licences and the effect of an injunction would be to close or substantially affect the running of the factory.'

An award of damages was more likely—

> 'eg payment of a sum of money to compensate the claimants for any actual losses they have incurred. Actual losses are likely to be physical damage (replacement windows and vehicle damage costs have been claimed) and diminution in value/rental value of their properties. We have no details of the likely amounts in relation to these items.'

[25] A detailed response to the claim was sent by CLC on 14 January 2010. Commenting on the evidence thus far produced they said 'your clients' case on causation, actual nuisance and damage incurred is weak and totally unsubstantiated'. The claim for an injunction, they said, was 'highly likely to fail' and the application for a GLO would be resisted. Hugh James sent an equally detailed response dated 8 February 2010, and the following day emailed to say that they would be issuing the GLO application that week, with a view to hearing in March.

[26] It appears that on 9 or 10 February Mr Dickinson may have chased up his inquiry about the tax consequences of the share buy-back, since on 10 February he was sent a further copy of an email containing tax advice sent the previous November. That email warned him of the possibility that changes to the tax regime might be made in the forthcoming budget. He responded to the tax partner the same day saying:

> 'I wish to proceed with a share redemption for all but 10,000 of the ordinary shares in the company …
>
> In practice I will loan the redemption proceeds back to the company, except probably the [pension scheme's] portion but secured by charges against the company's assets.
>
> Company reorganisation
>
> I propose to sell Norse Precision Castings Ltd to myself for a nominal sum as it still has a negative net worth. Now that it is generating good profits it should be able to use its portion of the small companies tax band …'

[27] At this point Mr Dickinson evidently asked the auditors to prepare documents to put the share buy-back into effect. On 17 February he told them that he wished to proceed 'with all transactions to be completed before budget day and certainly before 5th April'. In response, among other things, the auditors raised a query about the value of the shares in Norse, saying:

> 'What price do you think you could get for the company if you sold it to a third party? Although it currently has negative net worth, you say it is now making profits, so would it be possible to sell it for more than a nominal sum? If the answer to this is Yes, then please let me know as your tax position will be based on this higher value.'

There is no evidence in the documents of any response by Mr Dickinson on this point.

[28] There was at this time a considerable correspondence between Mr Dickinson and CLC in relation to the potential claim and the application for a GLO. On 11 February 2010 Mr Dickinson informed CLC of an 'unwelcome development', ie that the company had received a summons in the magistrates court issued by the local council alleging odour detectable outside the company premises in breach of permit. He took the

view (for which there seems to have been some support) that this prosecution out of the blue was probably instigated by Hugh James putting pressure on the local authority because a successful prosecution would bolster the civil claim.

[**29**] On 18 February 2010 CLC wrote following receipt of a witness statement from Hugh James in support of the GLO application. Based on that statement, they informed Mr Dickinson:

> 'The number of claimants has reduced to 72. There are details … of how much they are claiming. The amount of general damages ranges from £800,000 to £2.4m – on top of which they claim actual damage such as repairs and reduction in value to their properties – as yet not quantified. Clearly all the stops must be pulled out to defend this claim … Difficult to estimate a trial date at this stage – a rough estimate would be near the end of this year.'

[**30**] On 19 February 2010 CLC made a note of a telephone discussion with counsel in relation to the GLO. This begins with a discussion of expert evidence that the company might assemble (none had been produced to that date although Mr Dickinson had had discussions with potential experts). Counsel is recorded as saying 'the expert evidence is probably our best argument for opposing the GLO, on the basis that the claimants' properties vary so much and it is a rubbish claim.' Counsel said that she now thought the odds of opposing the GLO were 40% to 60% against. Three days later, CLC sent some further documents to counsel—

> 'just received from the client relating to the recent summons for allowing odours beyond the permit … Presumably we will need the client/expert to persuade us how (hopefully) "insignificant" the breaches referred to are? … I fear the chances of successfully opposing the GLO are again reducing. There seems to now be quite a bit of prima facie expert evidence confirming that odour and noise has escaped so as to constitute a breach of permits. I know that the defendant has to be given a chance to serve expert evidence in response, which our client has not yet done, and breach of permits is not the same as nuisance. However this does potentially weaken our argument that the claim is totally unsubstantiated.'

This was reported the same day to Mr Dickinson with a request that if possible the proposed expert should 'give preliminary evidence to the judge to strengthen our arguments, at this early stage'.

[**31**] On 22 February 2010 Mr Dickinson informed CLC that he had reached agreement to buy another company which operated a foundry business. That company was called Procast Ltd, and its business was very similar to that of Norse Castings Ltd. His email said:

> 'Although the world is falling around my ears with regard to the nuisance case … I have just agreed to buy another foundry.
>
> … It is another of those cases where a speedy transaction will enable me to buy the business very advantageously. The business is in Hitchin which is convenient … to combine with our Bedford factory.'

a The intention, which in due course was put into effect, was to transfer the business of Procast to Norse, combining their operations such that, it was hoped, the additional turnover would significantly increase the profitability of Norse.

[32] On 24 February 2010 Mr Dickinson sent a further email to the tax partner. The liquidators rely on this email to a significant extent as, they
b say, indicating his state of mind and intentions at the time. He said he intended to proceed with the proposed share buy-back, and then:

> ‘**Sale of Norse**
>
> I bought Norse out of the company as of 1 October 2009 at the same nominal £1 paid for it. Since more than 14 days has passed I do not
> c think we can notify the IR by way of election(?). I would be optimistic any IR challenge to the valuation can be disputed due to the high negative net worth, the short time that had elapsed since it was purchased and at that time the massive Shell gas bill that had just appeared.
>
> **Protection of Norton Aluminium/Group Litigation Proceedings**
>
> d It occurs to me that I might usefully protect future profits, as well as providing a vehicle with trading history to possibly Phoenix the Norton business if this case goes badly against us. I am proposing [to use a Newco] to buy the ingots from Oldco [Norton Aluminium Ltd] at cost or even a small loss, then for Newco to sell the ingots to the customers at the full selling prices.
>
> e In this way future profits will reside in Newco and be protected from proceedings against Oldco. It will allow Newco to establish a trading history and cash reserves in case it has to Phoenix the Norton operation.
>
> … We would not be disadvantaging existing creditors as Oldco’s asset
> f base is unaffected …
>
> Do you agree it makes sense or have any other suggestions?’

[33] The response in relation to the sale of Norse Castings was: ‘As you say there would be a very strong case in arguing the low value given the balance sheet of the company.’ On the second point, the tax partner clearly
g (and in my view rightly) interpreted what was being proposed as a scheme to move profits out of the existing company so as to insulate them from the potential claim. He said: ‘We can see tax problems from this approach which is effectively transferring part of the trade and future profits to [Newco] at an undervalue.’ He suggested an alternative however, evidently seeking to meet what he understood was Mr Dickinson’s objective:

> h ‘The alternative would be to insert a new holding company above NAL … Assets could be transferred up to the new company by dividends in kind leaving just the trade behind. Any claims would be against the subsidiary only leaving the core of the assets untouched.’

[34] On 1 March 2010 there was a meeting at the factory involving
i Mr Dickinson, Katharine Holland QC and Lisa Ginesi, the solicitor at CLC who was dealing with the case. Mr John Grant, an expert on noise, also attended, as did Mr Paul Griffin, formerly an environmental health officer at the local council but now employed by the company. The solicitor’s note records that when at the council, Mr Griffin had dealt with about 20 people

who had complained about the factory, of whom five were regarded as 'hard-core complainants'. Mr Dickinson accepted that 'there could be some seepage of odours when there are strong winds' and that odours from the foundry may have been noticeable before 2006, but that new machinery had been installed in that year 'and odours are barely noticeable now. Even with the best possible equipment, it would be impossible to eliminate all odours'.

[35] Mr Morgan points to part of the note which said 'Counsel referred to the possibility of our making a cross-application for summary disposal [of] the claim', and a little later:

> 'The expert view, on reading the papers, is that it is a "try on". Counsel confirmed that what we are trying to achieve is for him to create an expert report which will give this conclusion.'

The expert view referred to must be that of Mr Grant, and although it is apparent from the note that he expressed views on areas other than his own (ie noise) it is unclear whether this comment is restricted to his area of expertise or intended to be more general. It does not appear that counsel can have expressed any favourable view as to the prospects of applying for summary judgment, since that matter is not referred to again in the note. Certainly no such application was made, or apparently seriously considered thereafter; Mr Dickinson did make one inquiry as to whether it was still under consideration but cannot have received a positive response.

[36] Immediately after the reference to the possibility of a summary judgment application the note goes on to say: 'A claim relating to odour is more difficult.' That may be a reference to the acknowledgment that odour was detectable outside the factory premises, and that it had been more substantial prior to 2006. This note does not, therefore, indicate that Mr Dickinson was receiving advice that the claim was so weak that an application for summary judgment was a realistic possibility. At best it would seem that it was mentioned as a possibility, but never pursued.

[37] Mr Morgan also points to a section at the end of the note in which the possible quantum of the claim is discussed. It records:

> 'Counsel referred to the Privy Council case of *Alco Minerals* 2002, which related to a smelting process in which £600 general damages were ordered. We are a much smaller organisation, and the £600 was not per year, it was a one-off payment.'

I should mention that Mr Barker submits that if this note correctly records what was said about *Alcoa Minerals of Jamaica Inc v Broderick* [2002] 1 AC 371 it is a serious misunderstanding of the facts and result of that case. Mr Dickinson cannot however be criticised for not inquiring beyond what he was told about it.

[38] Mr Dickinson's evidence was that he had taken note of this and relied on it to assume that the downside in respect of damages exposure was of the order of £60,000, on the basis that there were about 100 potential claimants and that £600 was the likely level of damages they might each recover. I do not, however, believe that he genuinely thought that £60,000 was the likely limit of liability if the claim was lost. There is no reference to any such assumption in any subsequent document. On the same page of the

note is what is evidently his own evaluation of the likely result if the claim was lost:

> 'The factory currently [makes] profits [of] about £300,000–£500,000 per year. If the claim is successful against the factory, the factory and company will close down. Henry has various other businesses which he is involved in, in different company names, one of which is a foundry in India.'

[39] Plainly, Mr Dickinson was anticipating a possible exposure so great that it could not be afforded, notwithstanding the significant level of profitability of the business. No doubt the total exposure included costs, but there is no indication in the note that he was approaching the matter on the basis that even if the likely level of damages could be easily afforded, the costs would be so great as to wipe the company out. Nor is there any indication that the risk of closure is not because of the financial effects of an adverse judgment but because of the risk of an injunction. I note also that Mr Dickinson appears to have been making the point that even if Norton Aluminium Ltd were to close down he had other businesses 'in different company names'. One of these, no doubt, was Norse Castings, which he had just arranged to sell to himself for £1. He referred specifically to the foundry in India. Although at that time Norton India remained a wholly owned subsidiary of Norton Aluminium Ltd, he had of course previously indicated that he might take steps to arrange for a majority shareholding to be held elsewhere, partly so that any receiver of Norton Aluminium Ltd would not be able to control it.

[40] Mr Dickinson continued to have discussion with the tax partners at the auditors about the possibility of the share buy-back. He had made various proposals about the way in which this could be implemented, and on 4 March 2010 the auditors sent an email suggesting that in order to settle on a specific plan the tax consequences of which could be identified they should have a meeting. They asked him to let them know 'how you would like to proceed so that we can pick up on all your queries and deal positively with all your ideas about the group.' They clearly wished to know what Mr Dickinson's objectives were. Mr Dickinson replied:

> 'I believe you understand the nub of the matter – I want to reduce the net worth of the company by approx £2.5m – more if it is easy or straightforward – by extracting funds (which will probably be reinvested as shareholders loans secured against assets, charges registered at Companies House). I want to accomplish this in the most tax efficient manner and before 5th April when we know or expect that tax rates will rise substantially.'

[41] On 22 March 2010 the auditors advised that the most tax efficient way of proceeding would be to buy back up to 2.5m shares at nominal value. They sent a note setting out the effects of this and a possible alternative, which commenced: 'Objective to extract £2.5m from the company in the most tax efficient way.' They prepared and sent documentation to Mr Dickinson intended to achieve this proposal, comprising three share purchase agreements (one for each of the selling shareholders) and a notice of, and draft minutes for, an EGM to approve the purchase. In the end, these documents were not signed before the budget

and Mr Dickinson decided to delay the share buy-back until after the start of the next tax year. He eventually signed these documents on 10 May 2010. Mr Dickinson's case is that the buy-back took effect on that day.

[42] The company did not make actual payment of the purchase price of the shares, in the sense of a transfer of funds to bank or similar accounts of the shareholders. Mr Dickinson's intention, as appears from the earlier emails, was that the funds should be left in the company. He did not however immediately execute any document to record the terms on which this was to happen. His evidence was that he gave instructions on that day to Mr Tranter to make appropriate entries in the company's books. Journal entries were made, dated 31 May 2010, recording transfers from share capital account to loan accounts. Mr Tranter's evidence was that the entries were probably actually made in the books during the first week of June, but dated for convenience on the last day of the previous month. Though his witness statement referred to a 'verbal loan agreement' he said he had only had a brief conversation with Mr Dickinson when he was told that the buy-back would be going ahead and the money would be left in as a loan. At the time the terms had not been agreed so he assumed it would be 'normal commercial terms'. He recalled being told it would be interest free.

[43] Mr Dickinson began to explore the process of documenting the intended loans afterwards. On 11 May 2010 he sent an email to a solicitor at CLC saying:

> 'I have reorganised the balance sheet of Norton, essentially causing the company to buy back most of its share capital from the shareholders to take advantage of the current low rates of CGT. However I will still be leaving most of the cash within the business, but I want to ensure that the monies are as protected as reasonably possible by registering charges (ranking behind HSBC in priority) against the company for the amount of the indebtedness … Presumably separate charges will be required for each shareholder. The initial amounts are as stated although I expect to repay the loans at least in part as profits and cash coming over the next few years … Please advise cost and time scale to put in place.'

[44] In answer to the solicitor's query as to whether the loans were to be 'formally documented … or is this simply by way of ledger entry?' Mr Dickinson said: 'No formal document is proposed for term of loan or interest.' The solicitor prepared a draft debenture, initially limited to securing the loans representing share proceeds. On 13 May Mr Dickinson asked him: 'I have other shareholder loans in the business and may have in future – can these be protected by this charge also?' The draft debenture was amended so as to secure all monies due from time to time.

[45] In relation to the assets charged he said:

> 'I am particularly concerned to get control in the event of a receivership of the shareholding in Norton Aluminium India Private Limited (and probably the loans owned by India to the company).'

Later the same day he told the solicitor:

> 'I certainly would not want a liquidator to be able to challenge this (excepting that such payments shouldn't be made at a time when the company is unable to pay its normal creditors).'

I have no doubt, in the circumstances, that what Mr Dickinson considered to be 'normal creditors' did not include the potential environmental claimants. In fact of course if an effective security was granted payments could be made to the secured creditors in priority to others, including 'normal' creditors.

[46] After revision the debenture was executed and sent to the solicitor for registration, probably on or about 9 June, as he received it on 10 June. The document then bore the date 20 May 2010, but the solicitor with Mr Dickinson's authority re-dated it twice before it was eventually successfully registered on 25 June with the date of creation said to be 3 June 2010. A claim was pleaded that the re-dating was ineffective and consequently the registration was outside the period of 21 days from the date of creation imposed by (at the time) the Companies Act 2006, s 870, but Mr Morgan pointed out in his skeleton that s 869(6)(b) provided that the certificate of regulation is to be conclusive evidence that the requirements as to regulation have been complied with. The effect is that no evidence may be admitted to the effect that the charge was in fact created more than 21 days before the date of registration, and Mr Barker rightly abandoned that claim.

[47] On 20 May 2010 Ms Ginesi sent an email saying that she had read through a supplemental witness statement served on behalf of the claimants in relation to the application for a GLO. She said:

> '… My initial comments:
>
> 1. Nothing much new in it.
>
> 2. Their references to the complaints received are so totally vague and unspecific … as to carry little weight (how many complaints were there? In what area?).
>
> 3. They refer to rather questionable "evidence" to suggest their claims have merit … The above evidence is weak – particularly as the claimants have had several years to get their case together and this is the best they can come up with?!
>
> 4. Paragraph 34 is very telling. It seems without a GLO there would be no after the event insurance … Query whether the claimants would then have enough confidence in their claims to carry on, knowing that they have to pay the costs if they lose.
>
> I do believe that it is unfair to allow a GLO to be made on the basis of such a weak case. The GLO procedure is being abused as a means by which small individual cases with weak claims can gain disproportionate strength and obtain funding from being grouped together. We really do need to have a robust judge to reject the GLO.'

[48] Notwithstanding that, the GLO was made by Flaux J at a hearing on 26 May 2010, naming 72 claimants but with the possibility of course that more could apply to register claims and join the group litigation. Following that hearing, Ms Ginesi wrote two letters; the first estimating that costs including VAT and disbursements to a fully contested trial 'could be in the region of £500,000' and the second discussing the tactics, but not the possible amount, of a Pt 36 offer. This letter made clear that any such offer would involve payment of the claimants' costs to the date of acceptance.

[49] On 2 November 2010 there was a conference with counsel and Mr Buck, an expert witness on issues of odour. Mr Buck opened by saying

that he thought reports were being ‘cobbled into a court case which does not hold up very well’. Leading counsel Ms Holland QC is noted as saying:

> ‘Lawyers take that view and certainly where the case is going we seem to be getting more optimistic after last week’s hearing. Judge seeing through the other side.’

The meeting went on to discuss the difficulty of obtaining evidence and making any objective assessment, particularly on issues of odour.

[50] On 1 February 2011 Ms Ginesi wrote to discuss the possibility of mediation and making a Pt 36 offer. In that email she said:

> ‘As we have said throughout, there is no doubt that we continually need to review the possibility and cost effectiveness of paying some money to the claimants to try and end this claim to avoid the massive costs of a contested trial in which the outcome can never be predicted with any accuracy …
>
> Please note that considering settlement options does not mean we think your defence is weak – rather that there may be a commercial gain in taking steps to end this claim now. We have seen some very supportive witnesses who will contradict the claimants’ evidence and we have also had some positive comments from our expert Geoff [Buck] …
>
> It is difficult to get a good grip on how much these claims may be worth and what sort of settlement figures should be offered …
>
> The different possible outcomes in this claim are dramatically wide-ranging from – this claim failing and your recovering the majority of your legal costs under the ATE insurance to – this claim succeeding and you being faced with a £1 million plus claim which may very well destroy the company. No doubt [Hugh James] will be fully aware that any victory at trial will be Pyrrhic if Norton go bust.
>
> Please let me have your views on whether you are prepared to make an offer at this stage and the possible amount …’

[51] In response to this, Mr Dickinson said:

> ‘I think it is highly unlikely we will agree to settle until or unless expert evidence persuades us of their case … As you say, if HJ were to win on the scale they claim their victory will be Pyrrhic and they will get nothing.’

[52] A few days later on 11 February 2011 in the course of the discussion about possible evidence, Ms Ginesi noted:

> ‘Henry confirmed that the balance sheet of the company shows net equity of approximately £1.5 million. However if a receiver was appointed and the assets sold, most of the machinery would be sold at far smaller values which would take the equity down considerably, and there will be nothing left for unsecured creditors. Henry took the equity in the property (sic) down from £2.6 million to £100,000 a few years ago. He referred to various steps taken to restructure the company last May. There was a buy-back at par of shares and £2.5 million worth were converted into shareholders loans. £1.7 million shareholders loans were left in the business, secured by a fixed charge against the company’s assets. If a receiver were appointed, the first £2.5 million

> from any realisation would go to the secured creditors. The next £1.7 million would go to the shareholders' loan, which is effectively Henry. The balance, of which there would be very little, would be for unsecured creditors …
>
> At this stage, it is difficult to know whether the arrangements are bombproof and/or capable of not being set aside by a receiver-liquidator … in the event of an unfavourable judgment.
>
> Henry's view is that he would like to fight this all the way, he thinks he is going to win. He sees no reason to settle …
>
> LG asked whether Henry would like an estimate of costs to trial, Henry said that this would not be necessary. '

[53] There was a further conference with counsel on 20 April 2011. It seems that at that point counsel's view of the prospects of success was positive. Discussing the possibility of an amendment to the pleadings and/or an application to revoke the GLO, Ms Holland is noted as saying:

> 'They are already worried about that case. We can write some aggressive letters to them. Most likely response to this – desperate attempts to settle. Personal view – we reject and push them to the wire. Huge gamble for them to take … Reality – they have left it too late to try to settle … We should not be going to them with an offer. Wait for them to come to us.'

In the same conversation, Mr Dickinson is noted as saying: 'If they were to win – Pyrrhic victory anyway.'

[54] On 9 June 2011 Ms Ginesi raised the possibility of the company obtaining its own ATE insurance. She said that it was likely that this would only be available if leading counsel could advise that the prospects of successfully defending the claim were at least 60%. In this respect she said:

> '60% is a high threshold – I was once told by a barrister, now sitting as a judge, that even the best and simple cases should not be assessed at above 70%.
>
> My understanding is that although Katharine [Holland QC] is prepared to say that your chances of success are currently over 50%, she is unlikely to say they are as high as 60%.
>
> However, it is worth noting that this insurance would only cover the other side's costs if you lose. It would not cover any claim for damages which would have to be met by the company. I recall HJ indicating that the claim for damages is about £2.5 million – although this is obviously their best/best scenario.
>
> You say that if you get an adverse decision you will probably fold the company. It may therefore be that the damages claim could tip the company over – with or without the additional claim for legal costs which we are trying to insure against. If this were to be the case, there may be little point in taking steps to try and meet the costs order or seek insurance to cover it.'

[55] Mr Dickinson responded asking her to pursue the possibility of obtaining insurance. He said:

> 'After the Biffa case it seems to me highly unlikely that many of the claimants would be adjudged to have valid claims even if HJ are successful and therefore that the amount of damages awarded would be survivable …'

There is no record of advice either by Ms Ginesi or by counsel confirming this view on the part of Mr Dickinson. In his evidence, Mr Dickinson maintained firmly that although he had never been advised that the prospects of success were higher than about 52%, in view of the comment that 'the best and simple cases should not be assessed at above 70%' prospects of success, in his mind this figure should be scaled up, if a case that was guaranteed to win was only assessed by lawyers as having a 70% prospect (as he put it '70% means 100%'). If the lawyer said the case had a 52% prospects of success he considered the chances of success should be multiplied up in the same proportion, which would produce a figure of about 75%.

[56] Notwithstanding the vigour with which Mr Dickinson repeatedly pressed this point, I do not accept that that was what he in fact believed. He is far too intelligent and knowledgeable a businessman to believe that lawyers have some peculiar way of expressing percentages, or that if they do so they give unrealistically low figures out of irrational over-caution. He was, in my view, well aware that what Ms Ginesi meant by this comment was that even a case which appeared to be straightforward when viewed from one party's perspective carried real uncertainties and risks of litigation which had to be factored into any prediction of the likely outcome. Any apparent discounting of the chances of success therefore represented real risks which the client ought to take into account, rather than imaginary ones that he could safely ignore.

[57] The 'Biffa' case referred to was *Barr v Biffa Waste Services Ltd* [2011] EWHC 1003 (TCC), [2011] 4 All ER 1065, which was also a group litigation action in which Hugh James represented the claimants who complained of odour, in that case from a waste disposal site. Coulson J held that although the fact that the site operated within the terms of an authorisation by the Environmental Agency did not amount to a statutory defence to claims in nuisance, the authorised operation constituted a reasonable use of land such that claims in nuisance could only succeed if negligence was established on the part of the operator. Further, loss was not established on the facts in the majority of claims, and even if it had been would have been limited to £1000 per household per annum. Although this was clearly encouraging from the company's point of view, Ms Holland's advice at the conference on 20 April 2011 had been 'the Biffa case is good for us but not end of story; lot of issues to distinguish their case from ours.'

[58] On 24 June 2011, shortly before the first trial date, Mr Dickinson sent Ms Ginesi a copy of the company's most recent accounts, which he said were to be filed imminently but 'whether HJ have the financial acumen to understand them is another matter'. He said:

> 'The key document is the balance sheet … This shows a net worth of £2.7 million …
>
> Receivers would expect to realise 20% of book value from fixed assets, and perhaps 40% from stock, so perhaps £850,000 from a book

value of £2.6 million. Receivers usually anticipate recovering about 80% of monies due from trade debtors.

Norton India is a start-up and lost £400,000 in the past year and is heavily indebted to both Norton UK and state bank of India. In a receivership situation the investment [ie the shareholding] is probably valueless and any debts owing would have to be heavily discounted. The realisable value [of the inter-company debt] in receivership is probably less than £500,000, ie a discount to book value of £1.5 million.

Norton UK does not own the property from which it operates. The land and buildings shown in the fixed assets relate to buildings erected on the rented land. These have no value in a receivership situation without ownership of the property.

Norton UK has a £2.5 million invoice discounting line, which is fully utilised at times dependent on cash flow during the month …

£2.5 million of share capital was repurchased by the company in May 2010 at par, financed from accumulated reserves. Much of the proceeds of this redemption were retained in the business as shareholder loans secured by a charge over the company's assets.

In the event receivers being appointed Norton, unsecured creditors would be unlikely to receive any distribution at all.'

[59] Ms Ginesi passed this information onto a colleague, to whom she said: 'To cover our backs I will remind Henry that we have not advised on this issue as to whether any transactions can be set aside and monies diverted back into the company.' She arranged for a conference with specialist counsel, Mr Paul Greenwood, which took place on 25 July 2011. Mr Greenwood was sent a briefing note, prepared by Mr Dickinson, in which he set out brief information about the claim and then a section headed 'Financial Background'. He gave brief details of the share buy-back, and of the transfer of the property to himself in 2005, which he said was still leased back to the company at an annual rent of £40,000 'paid monthly'. In relation to Norton India he said:

'The company now owns 49% of Norton Aluminium India … The balance of 51% of the equity is owned by H Dickinson who used the cash released by the share redemption to subscribe for the increased share capital. Prior to 2010 NA UK owned 100% of NA India until the capital base was substantially enlarged. The shareholders have signed (acting by H Dickinson on behalf of each party) a share subscription agreement obliging each to sell the other their shares in the company in the event of a default and according to an agreed basis for determining the price to be paid.'

Mr Dickinson set out at the end of this note the questions he wanted Mr Greenwood to advise on:

'Can any of the above transactions be set aside?

Can the shareholders continue to extract cash and reserves by way of salary and dividends while the litigation is ongoing? Is there any limit thereto?

Is the Indian subsidiary appropriately structured to protect it from UK creditors should NA lose in the litigation?

Is NA obliged to provide any more than the costs of defending the litigation until such time as judgment and/or an order for costs is made against it?

Do the directors have any liability to the company's current and future creditors for the actions taken to date should the company cease trading?'

The flavour of this note, in my view, is not that Mr Dickinson is concerned that innocent transactions entered into for other reasons might now be accidentally put at risk, but that he was describing steps taken and those he wished to take as a result of which the company would not be able to meet the claim and seeking confirmation they were effective for that purpose.

[60] The note of counsel's advice given in conference on 26 July 2011 has been disclosed, presumably because the advice was sought on behalf of, and paid for by, the company and so is now an asset available to the liquidators. I do not propose to set out the advice given, but it is relevant to note the following matters:

(i) Counsel noted that the effect of the share buy-back had been to convert shareholders' equity into secured loans, which would not benefit creditors, and asked what was the purpose behind this transaction. Mr Dickinson said that the government had been about to increase tax rates and the transaction was a way to beat the budget. The company had distributable reserves and was then and had remained solvent, even taking into account the litigation, because of the view he took of the prospects of success.

(ii) Counsel advised that it was permissible for Mr Dickinson to remunerate himself at proper commercial rates, including paying a commercial rent for the property he owned. Mr Dickinson acted on this by increasing the rent payable from £40,000 to £120,000 per annum, which he back-dated to the beginning of the financial year (1 October 2010).

(iii) Mr Dickinson appears to have instructed counsel that the purpose of his own subscription of shares in Norton India was 'to avoid the costs of consolidation of the accounts'.

(iv) Counsel advised that it would be 'possible for the company to give suppliers retention of title and to take charges on the company's assets, if this is normal trading terms. This would only apply if there was fresh value or consideration from the suppliers.' It does not appear that counsel was told there was any pressure from suppliers for such a change, so it seems that the advice was being sought on the footing that the company would volunteer to improve the position of trade creditors, which in the context must have been with the aim of worsening the position of the environmental claimants, if successful.

[61] Offers to settle were made in the months running up to trial, but these were for very much less that the indicated amount of damages, and would have required Hugh James to accept payment of only a proportion of their costs. Mr Dickinson was vitriolic and contemptuous when these offers were not accepted. He continued to regard the litigation as having been generated and pursued by Hugh James solely for the purpose of running up enormous claims for costs for their own benefit. He was angry that they did not seem to share his view that if the claim was dismissed at trial this business model would be ruined because the company would seek payment of most of its costs and any other similar claims would become much less likely to settle. In a series of emails sent to Ms Ginesi in May 2012, he said:

> 'I think they have not understood and you need to get them to understand:
>
> We are confident their case will fail at trial, however we are prepared … to give them a face-saving way out … 4 claims succeed, we pay 4/132 of their costs, they pay 128/132 of our costs …
>
> The reality is they will lose everything at the end of the trial, including probably every other case they are working on once their case is comprehensively defeated … Even if they were to win (which we think very unlikely, but nonetheless they cling to this belief) they will recover nothing (which I think they now believe).
>
> It is not a question of finding a settlement that is affordable by Norton – I will not agree to any such settlement. Their claim will fail on the facts of the case, and MUST fail for the sake of the entire industry in this country.
>
> They have lost this case long ago in terms of enriching them personally, irrespective of the outcome – they only realised this at the mediation – but are still trying to negotiate a settlement that involves a big payout to them. They seem to think that I would prefer to work for them for years rather than allow my business to go bust. The reality is I will go bust rather than pay them a penny.
>
> I want them to realise there will be no payout for them – win or lose, and no matter what costs order the judge may make (and this I think they have understood) – and given that situation and their need to try and protect their position with regard to the other cases they have underway perhaps they should consider a face-saving way out of this as I have proposed. … They were pretty slow when it came to realising that they would get nothing if they succeeded in securing a massive costs order against us.
>
> To me it is very clear that their business model is to put maximum pressure on achieving a settlement: if it goes to trial their chances of winning are very uncertain and their chances of recovering costs are considerably worse, especially in our case.
>
> They therefore HAVE to avoid going to court … They will not get costs either way so that is now immaterial.
>
> If you can tactfully convey this in a manner to be understood by a child, just maybe they will see our offer in a different light as a solution to a very real problem. It will have to go well above [the normal fee earner's] head.'

[62] These emails make clear that Mr Dickinson was determined that there should be no payment of any substantial amount to the claimants in respect of their costs. He would not entertain any settlement, regardless of whether it could be afforded, that resulted in any amount going to Hugh James that would reward them for pursuing the claim or encourage them to bring others. If they were not willing to accept a settlement that left them substantially out of pocket, he would fight on and expected to win. However he intended and expected that the company would go into insolvency in the event of a judgment against it, that the outcome would be that the judgment and any costs order would be unsatisfied, and he had conveyed this to Hugh James at the mediation to persuade them to settle.

There is no indication that this was a recently formed approach; indeed the *a* reference to Hugh James having lost the opportunity of reward 'long ago' but realised it 'only recently' suggests that he considered the steps he had taken to restructure the company had rendered it judgment-proof.

[63] The trial before Judge McKenna was protracted. It began on 28 May 2012 but did not conclude until 3 July. In August, the judge circulated a draft judgment in which he dismissed the claims based on noise, smoke and *b* dust, but upheld 15 of the 16 lead claims insofar as based on odour. The damages awarded to those claimants would total some £160,000, and if extrapolated to the other claimants the total was estimated at about £1.2m. In addition there would be a claim for costs, yet to be determined but based on indications given before trial Hugh James would seek several million pounds. The company obtained permission from Judge McKenna to discuss *c* the draft judgment with an insolvency practitioner, Mr Haslam of Begbies Traynor.

[64] Mr Dickinson sent Mr Haslam on 25 August 2012 a statement of the estimated outcome for creditors in an administration. He considered the realisable value of stock and plant to be much less than book value in these *d* circumstances and, estimating the eventual value of the claim for damages and costs at £2m, projected a dividend to unsecured creditors of about 8.8p in the pound, or £176,000 in all. He suggested an offer to compromise before judgment was handed down, with a 'starting point' of £150,000, saying: 'That we could afford in cash subject to continuing credit from our suppliers. Much more would have to be staged.' He suggested they should *e* aim for an 'endpoint' of £300,000.

[65] In the end, Mr Haslam put forward on the company's behalf a series of offers, all of which were rejected. The final offer was to pay a total of £1m, of which £200,000 would have been payable within 60 days and the balance spread over 44 monthly instalments. Mr Haslam's advice was, apparently, that any greater offer would have led to the company trading *f* whilst insolvent.

[66] The company went into administration on 18 September 2012, and the administrators immediately completed a prepack sale of most of its assets to a company controlled by Mr Dickinson for £425,000. These amounts were significantly less than Mr Dickinson had estimated on 25 August. Later, an additional sale of the company's subsidiary Hytec *g* Castings Ltd and the debt owed to its parent was concluded for a further £75,000.

[67] Judgment was formally handed down on 28 September 2012 (see *Anslow v Norton Aluminium Ltd* [2012] EWHC 2610 (QB), [2013] All ER (D) 03 (Jan)). *h*

THE TRANSACTIONS CHALLENGED

Transfer of freehold premises in 2005

[68] Notwithstanding the board minute produced recording a meeting between Mr Dickinson and Mrs Dickinson on 14 September 2005, both of them accepted in oral evidence that no such meeting had taken place. *i* Mr Dickinson had simply instructed solicitors to produce the sale documents, including the minute, and signed it himself, which he regarded as sufficient. The pleaded case however is not that there was no meeting, but that it was inquorate and ineffective. I should say that there is also no plea either that the sale amounted to a substantial property transaction that would have been voidable unless approved by shareholders, or that it was a transaction at an undervalue, and thus there was no valuation evidence before me.

[69] The pleaded case of Mr and Mrs Dickinson, supported by their written evidence, was that there had in fact been such a meeting. This was wholly undermined by their oral evidence, with no satisfactory explanation for the change of position. Mr Morgan accepted that if there had been a meeting there could have been no valid resolution of the directors, because by virtue of reg 84 of Table A, which is incorporated in the company's articles of association, Mr Dickinson was not entitled to vote on the resolution or to be counted in the quorum. Since the quorum was two, Mrs Dickinson could not have passed the resolution herself, even had she been present.

[70] It is pleaded, and Mr Morgan accepted in closing, that in consequence the purported agreement for sale was prima facie void and Mr Dickinson held the property on trust for the company. He submits that the members of the company could however have ratified it by their unanimous consent or acquiescence, in accordance with the *Duomatic* principle (*Re Duomatic Ltd* [1969] 1 All ER 161, [1969] 2 Ch 365) as to which the onus of proof is on Mr Dickinson. His pleaded case (reply, para 39A) is that the members unanimously informally either approved or acquiesced in Mr Dickinson voting at the meeting and counting in the quorum by virtue of his own presence at that meeting, and similarly either approved or acquiesced in the sale by virtue of Mr Dickinson's own actions in executing it.

[71] This plea depends upon Mr Dickinson's actions effectively being the actions of all of the shareholders, or upon his having authority to act on behalf of each of them. Mr Barker was prepared to accept that Mr Dickinson should be treated as having authority to act on behalf of his own settlement. He was not however the sole trustee of the pension scheme and cannot be regarded as being the alter ego of the trustees collectively. There is no plea that he had authority to act on behalf of the other trustees of the pension scheme, nor is there any evidence from which I can conclude that he had such authority.

[72] Mr Dickinson said in evidence that he regarded himself as able to act on behalf of the pension scheme in all matters since he had established it and he and his wife are the beneficiaries of it. The best evidence he could produce in support of that however was a letter written by the professional trustee to a firm of stockbrokers confirming that the brokers could act on Mr Dickinson's instructions in relation to individual purchases and sales of investments. That was very far from a general authority even in relation to handling trust investments; the same letter makes clear that all investment proceeds are to be paid into an account over which the professional trustee has control. A further indication against the existence of any general authority is that when the professional trustee found out that Mr Dickinson had entered into the share buy-back agreement on the basis that the purchase price would be left outstanding on loan account, it did not agree to accept those terms and insisted that the proceeds payable to the pension scheme should be actually paid by the company into a separate account over which it had control.

[73] There is no evidence that the professional trustee was even told about the property sale, let alone that it actually consented to it or authorised Mr Dickinson to enter into it. Nor is there any pleaded case, or evidence, that the professional trustee came to learn of the property sale and, being aware of its potential invalidity, subsequently consented to it or acquiesced in it.

[74] Accordingly I reject the case that the purchase was authorised or ratified by the unanimous approval or acquiescence of the shareholders. Mr Morgan submits that Mr Dickinson ought to be relieved of liability pursuant to s 1157 of the Companies Act 2006, or alternatively s 61 of the Trustee Act 1925. It would be odd, he submitted, if Mr Dickinson was required to return the property to the company in circumstances where he was the majority shareholder, the professional trustee who might have objected at the time is no longer involved in the case and there was no pleading that the property was transferred at an undervalue.

[75] Section 1157 is potentially applicable 'in proceedings for negligence, default, breach of duty or breach of trust against … an officer of a company' and provides that if—

> 'it appears to the court … that the officer is or may be liable but that he acted honestly and reasonably, and that having regard to all the circumstances of the case … he ought fairly to be excused, the court may relieve him, either wholly or in part, from his liability on such terms as it thinks fit.'

Section 61 is in similar terms but relates only to personal liability for breach of trust.

[76] Assuming that the jurisdictional qualification is satisfied (Mr Barker did not submit otherwise) I am not persuaded that this would be an appropriate set of circumstances in which to grant relief under either section. I do not consider that Mr Dickinson can be said to have acted 'honestly and reasonably' in a situation where he has not, in my judgment, sought to act in the best interests of, or even with any proper regard to the interests of, the company as distinct from himself. The provisions of the articles that he was in breach of existed to ensure that the interests of the company were properly considered either by members or by disinterested directors. It is difficult, in my view, to regard it as appropriate to excuse a director from the consequences of breach of duty to the company if he has not himself given the consideration to the interests of the company, as distinct from his own, that compliance was intended to ensure. Further, insofar as the relief sought would have the effect of validating the transfer it seems to me this would be more than relief from a breach of trust and amount to the discharge of the trust itself. I doubt whether that could be justified (if at all) in any but the most unusual circumstances.

[77] There is no indication what benefit the company obtained from selling the site of its premises. There is no evidence that it needed to realise cash (I am not clear from the documents whether the purchase price was actually paid or simply charged to a loan account). There is no evidence that any valuation was obtained, and the sale price was less than 40% of the book value of the land and buildings. It seems the company did not

a recognise in its accounts the extent of this loss, since it continued to show the buildings (but not the land) as included in its fixed assets even though those buildings must have been transferred with the freehold and their value could not be realised separately from that freehold. This indeed was a point Mr Dickinson was keen to make when seeking to show that the company would be unable to satisfy a judgment against it.

b [78] Although there is no pleading that the transaction was at an undervalue, it seems clear that Mr Tranter at least was concerned that it might have been. It appears from the terms of the board minute that there must have been some discussion about the sale with Mr Tranter, and Mr Dickinson chose or agreed to record those concerns in the minute. His reason for dismissing those concerns was in part his own assessment, not
c supported by evidence before me, that he regarded the price as consistent with another local property sale. Had Mr Dickinson been acting honestly and reasonably in the interest of the company rather than himself, in my view he would have obtained a professional valuation to support the price being paid and put forward a reason why it was in the company's interests
d to sell and subsequently pay rent.

[79] There is similarly no indication why it was in the company's interests to agree to a lease excluded from the provisions of the 1954 Act. The price is also said to have been justified by the payment of a rent substantially below market value, but there was no guarantee that this rent concession would be maintained after four years (and indeed in this case it is pleaded
e that the 'undertaking' to enter into a further lease on similar terms was no more than a non-binding statement of intent). The rent being paid already represented a substantial yield on the sale price, and that fact, together with the possibility that the yield might increase very substantially if the rent increased in future, is another indication why the price may have been questionable.

f [80] In his evidence, particularly in relation to the share buy-back, Mr Dickinson maintained strongly that whilst the company was solvent, its own interests were to be equated with those of the members. That however can be no justification for the sale of the property to himself, since he was only one of the members and he failed to ensure, or at least to demonstrate, that the interests of the other members were properly protected by ensuring
g that the sale and lease back were for full value and on commercial terms.

[81] I therefore refuse the application for relief. The consequence will be that (inter-alia) Mr Dickinson will be found to have held the property on trust for the company throughout and liable to restore it to the company and to pay compensation equal to the amount of rent paid or credited to
h him, which is put at £415,000 in the defence.

[82] In the circumstances, it is not necessary for me to deal with the claim alleging breach of duty in back-dating the increase of rent. Had it been necessary to do so, I would have held that that decision was a breach of duty on Mr Dickinson's part. He was advised in conference with counsel that it would not be improper for him to increase the rent to a market rate,
i but in my judgment the note of that conference makes clear that his motivation for considering any increase in payments to himself was not to put matters on a normal commercial footing but to ensure that so far as possible arrangements were made to diminish the assets of the company so that they would be unavailable to the environmental claimants if they were

successful. Mr Barker did not seek to challenge the payments insofar as they represented periods after the date of that conference, but only the back-dated element. Although Mr Dickinson would have been entitled to follow his own interests as landlord demanding an increased rent for the future, he had no power in that capacity to demand a retrospective increase, and accordingly insofar as such a retrospective increase was agreed, it was by virtue of Mr Dickinson agreeing on behalf of the company to pay such an increase when it was not liable to do so. That agreement was made for an improper purpose and in breach of duty.

[83] Finally on this topic, although the liquidators plead a breach of duty against Mrs Dickinson on the basis that she participated in the meeting authorising the transfer of the property, and notwithstanding that she did not originally deny any such participation, since it is now clear on the evidence that she played no part in the transaction it would be wrong, in my judgment, to hold her liable for breach of duty arising from the transfer itself. She is now a joint owner of the property following the transfer into joint names by Mr Dickinson. If there is any dispute about whether she ought to be ordered to join in a re-conveyance to the company I will hear submissions, but provisionally it appears to me that it would be difficult for her to resist such an order unless she was a bona fide purchaser for value, which is not I think suggested.

The share buy-back

[84] It is common ground that a limited company may not acquire its own shares except in accordance with Pt 18 of the Companies Act 2006; see s 658(1). In default, s 658(2) provides that a criminal offence is committed by the company itself and any officer in default, and that the purported acquisition is void. Further, by s 691(2) 'Where a limited company purchases its own shares, the shares must be paid for on purchase.' The liquidators' primary argument is that the arrangements, whatever they were, for the purchase price to be left outstanding on loan account at completion do not amount to payment 'on purchase', and accordingly the buy-back transaction is void.

[85] Mr Morgan submitted that the loan arrangements were to be treated as payment. He relies particularly on the decision of Park J in *BDG Roof-Bond Ltd v Douglas* [2000] 1 BCLC 401. In that case a company agreed to buy one of its two issued shares from Mr Douglas for a consideration of £135,000, and simultaneously agreed to sell him a car and a property for £65,000. Only the net amount of £60,000 was paid in cash. The case was decided under the provisions of the Companies Act 1985, which was slightly differently worded; in particular in that it was structured so as to set out provisions applying to the redemption of redeemable shares, which were then stated to apply, mutatis mutandis, to a purchase of shares.

[86] One difference of language was that s 159(3) provided that 'the terms of redemption must provide for payment on redemption'. Mr Morgan drew my attention to the judgment where Park J said (at 412): 'In the case of an own-shares purchase I take this to mean that the terms of the purchase agreement must provide for payment on the purchase.' He pointed out that the terms of the share purchase agreements signed by Mr Dickinson stated that payment was to be made in full on completion. I doubt however that Park J is to be taken as holding that a provision in the

contract for payment on completion was sufficient if payment was not actually made, but in any event the statutory language has now been amended so as to make the point clear, and instead of referring to the terms of the contract it now requires that the shares are 'paid for on purchase'.

[87] It was argued that 'payment' meant only a payment in money. Park J said he disagreed, stating (at 412) that in his view if the company could satisfy its liability by payment of cash distributed by way of dividend, it would equally do so by a transfer of assets that it could have distributed as a dividend in specie (there was no question in that case of a payment out of capital). He went on to hold that in fact the contract in that case required payment of £135,000 in money, but as part of the wider transaction which Mr Douglas agreed to purchase property and the car, that obligation had been satisfied by set-off of the £75,000 payable by Mr Douglas against an equivalent part of the consideration payable to him by the company. There is no suggestion in this case that the consideration was satisfied either by transfer of non-cash assets or set-off against any obligation owed to the company.

[88] Mr Morgan submits however that it follows from this decision that it is not necessary for payment actually to be made in cash or by movement of money, and that the company discharged its obligation to pay the purchase price by making entries recording the debt in its accounting system and/or entering into an agreement under which that amount was lent back to the company by the selling shareholders, replacing the obligation to pay immediately with one to pay on deferred terms in accordance with the loan agreement.

[89] The liquidators take the point that Mr Dickinson had no authority to make any loan agreement, orally or in writing, on behalf of the pension trustees, nor could he validly commit the company to take a loan in a matter in which he was interested without a resolution of shareholders, which was not obtained (and for the reasons given above their approval cannot be taken to have been given informally) or a valid resolution of the directors. A minute was produced of a directors' meeting between Mr and Mrs Dickinson purporting to approve the loans, but it was clear from the oral evidence that no such meeting had taken place. Mr Williamson was not given notice of any such meeting and did not participate in it. Mrs Dickinson said she had been generally aware of the buy-back as a result of domestic conversations and agreed with it, but had not participated in any meeting, despite her written evidence that she had done so. Such informal conversations between some but not all of the directors cannot be said to amount to a resolution of the board, and even if they could it would be invalid since Mr Dickinson (and probably Mrs Dickinson also) had an interest and were by the articles excluded from voting. There was thus no valid loan agreement at any stage.

[90] I do not in any event agree with Mr Morgan's submission in principle. If the consideration payable under a sale transaction is not actually satisfied at the time of the transaction (whether by payment of cash, transfer of funds, transfer of some other property, set-off or in some other way) the result is that a debt automatically arises from the buyer to the seller. Recognition of this debt by making an entry in books of account does not constitute payment but an acknowledgment of the legal consequences of non-payment. Acknowledgment of it by entering into a

loan agreement, whether written or oral and whether entered into before or after the due time for completion, does not constitute payment on purchase but making or varying the terms of the arrangement such that payment is to be made at a later date, with the result that those terms do not comply with the statute. It would be wholly artificial to regard such a loan agreement as creating one obligation to pay money to the company by way of loan which was then 'set off' against the company's obligation to pay the purchase price.

[91] It is true that very similar results could be achieved by structuring the transaction so that money was actually paid by the company at completion and an equivalent amount was very shortly thereafter paid back to the company by way of loan. Alternatively, it might borrow in advance from a third party and use the funds to pay the selling shareholders. Provided in each case that the two transactions were genuinely separate, such that the arrangement was not a sham, it seems to me that this would satisfy the requirements of the section. Such an arrangement was made in *Customs and Excise Comrs v West Yorkshire Independent Hospital* (*Contract Services*) *Ltd* [1988] STC 443, in which cheques and credits for payment moved round between three parties so that the funds ended up where they started, but were held to have constituted 'payment' along the way. Mr Morgan submitted that there was no difference in substance between such arrangements and what had happened in the present case. I do not accept that; the end result may be similar, but the difference of substance is that the company has had to find from some source, albeit temporarily, the funds from which to make payment.

[92] If it were otherwise, nothing of substance would remain of the requirement the statute was intended to impose.

[93] It follows that on this ground alone, the share buy-back was void. I go on to consider the alternative cases put, however, in case the matter goes further and because they may make a difference to the positions of Mrs Dickinson and Mr Williamson.

SECTION 423 OF THE INSOLVENCY ACT 1986

[94] Section 423 provides, so far as relevant, as follows:

> '**423** *Transactions defrauding creditors*
>
> (1) This section relates to transactions entered into at an undervalue; and a person enters into such a transaction with another person if—
>
> (a) he makes a gift to the other person or he otherwise enters into a transaction with the other on terms that provide for him to receive no consideration …
>
> (2) Where a person has entered into such a transaction, the court may, if satisfied under the next subsection, make such order as it thinks fit for—
>
> (a) restoring the position to what it would have been if the transaction had not been entered into, and
>
> (b) protecting the interests of persons who are victims of the transaction.
>
> (3) In the case of a person entering into such a transaction, an order shall only be made if the court is satisfied that it was entered into by him for the purpose—

> (a) of putting assets beyond the reach of a person who is making, or may at some time make, a claim against him, or
>
> (b) of otherwise prejudicing the interests of such a person in relation to the claim which he is making or may make …'

[95] It is common ground that the company is a 'victim' in the circumstances of this case and that the 'purpose' referred to in sub-s (3) need not be the sole purpose of the transaction, nor (if there are more than one) need it be the dominant purpose. It is sufficient that it is 'a substantial purpose', and is not 'a trivial purpose' or simply the result of the transaction; see *IRC v Hashmi* [2002] EWCA Civ 981, [2002] 2 BCLC 489 at [23] and [39], per Arden LJ and Simon Brown LJ. Laws LJ agreed, saying (at [33]) that the question was whether the person concerned—

> 'was substantially motivated by one or other of the aims set out in ss 423(3)(a) and (b) in entering into the transaction in question. There may be cases in which, even absent the statutory purpose, the transaction would or might have been entered into anyway. That would not necessarily negate the section's application; but the fact-finding judge on an application made to him under s 423 must be alert to see that he is satisfied that the statutory purpose has in truth substantially motivated the donor if he is to find that the section bites.'

[96] Mr Morgan raised in his skeleton the question of whose purpose is relevant where a decision is taken by a board of directors. He referred to *BTI 2014 LLC v Sequana SA, BAT Industries plc v Sequana SA* [2016] EWHC 1686 (Ch), [2017] 1 BCLC 453 ('*Sequana*') and submitted that Rose J had suggested (at [494]) that proof was required that the purpose was shared by a majority of the directors. In fact what Rose J said was 'it is accepted that when considering whether [a company] acted with the s 423 purpose it is enough if the majority of the directors acted with that purpose in declaring the dividend'. I did not understand him to press this point in closing on the company's behalf, but in relation to the claims against Mrs Dickinson and Mr Williamson he submitted that Mr Williamson played no part at all in the material decisions, which were all effectively taken by Mr Dickinson. Insofar as Mrs Dickinson participated, notwithstanding her witness statement in which she said she had joined in the meetings referred to in the minutes, on the oral evidence of both Mr Dickinson and herself her participation was limited to the domestic discussions referred to above. She did say she was aware of the buy-back and agreed with it, but it would be difficult in my judgment to say that she gave it sufficient independent thought to form her own purpose in concurring with it, to the extent she did.

[97] In these circumstances I am in no doubt that to the extent the company participated in the buy-back transaction it did so because of the decisions and actions of Mr Dickinson, and his purposes are to be considered as also being the purposes of the company. There was in truth no collective decision, but to the extent the other directors lent any support to what Mr Dickinson decided, either by informal concurrence in the case of Mrs Dickinson or non-engagement in the case of Mr Williamson they must be taken to have allowed the company to act with Mr Dickinson's own purposes.

[98] Before examining what those purposes were, there is an issue

whether the buy-back (which is accepted to be a 'transaction' for the purposes of the section) was 'at an undervalue'. Mr Morgan submitted that it took the form of a sale, and that prima facie the value of an asset sold is not less than what a reasonably well-informed arms length purchaser would be prepared to pay for it. The onus was on the liquidators to show that the shares sold had no value at the time (no case being pleaded on the basis they were worth more than nil but substantially less than the £2.5m agreed) and they had provided no valuation evidence to that effect.

[99] In my judgment however Mr Barker was right to submit that a payment for purchase of a company's own shares is to be regarded as equivalent to a dividend or distribution to shareholders in return for which the company receives no consideration. In *Sequana* Rose J held (at para [502]) that a dividend was a transaction within s 423(1)(a) or (c). I understand her conclusion from the preceding paragraphs to have been that the company received no consideration for payment of the dividend, because it was not a payment in satisfaction of existing rights the shareholders held against the company but one that was discretionary in nature and amount.

[100] The position on a purchase of own shares is different inasmuch as the rights of the selling shareholder in relation to the shares in question are extinguished by the sale, but those rights are only to participate in dividends if and when declared and to participate in the distribution of assets on a winding up (or an earlier permissible return of capital, if and when made). They are not, in my judgment, to be regarded in the same light as claims enforceable against the company by creditors, the discharge of which amounts to consideration received by the company. Extinguishing the participation rights of one shareholder does not mean that the company is released from its (contingent) obligations to distribute profits or assets, but only that any such distribution is made to those remaining as members. The position of the company is no different, and the contingent benefit produced by paying to buy the shares in goes to the remaining members whose share in subsequent distributions is increased, not to the corporate entity.

[101] Further, although the shares sold were property in the hands of the selling shareholders the company does not in any sense acquire that property on the sale, unless it treats the shares acquired as treasury shares under the Companies Act 2006, s 724 (which it did not in this case). In other circumstances, by s 706(b) the shares are treated as cancelled and the amount of share capital is diminished accordingly. The result is that the company does not hold the shares as an asset that might be sold for value to a third party purchaser; instead they cease to exist. No doubt the company could in principle issue further shares in itself for money or money's worth, subject to appropriate authorisation, but that would be the case in any event, irrespective in principle of whether it had previously bought in any of its existing shares.

[102] Returning to Mr Dickinson's purposes, which were effectively also those of the company, I accept that at the time of the buy-back and other transactions in 2010 Mr Dickinson considered that there were good prospects that the company would defeat the claims that were threatened against it. It is difficult to be sure at this remove exactly how he regarded the chances of success because his expression of views to others, at the time

a and since, has been coloured by his outrage at the claims being brought at all and in particular the way in which they were promoted by Hugh James, and by his anger at the possible consequences for his company and for industry generally if such claims were likely to be brought and, worse still, succeed. Nor do I accept that his evidence now is necessarily an accurate reflection of his views at the time. In particular, as I have said, I do not
b accept that he regarded the legal advice he received, which at best insofar as expressed in percentage terms went no higher than 52% prospects of success, was to be interpreted as something more like 75%. He told his own solicitors he was concerned on the facts about claims based on odour, which were those that eventually succeeded.

[**103**] However, the claims at that stage were poorly formulated and not
c well evidenced, the level of support among residents was patchy such that there was the opportunity to obtain favourable evidence from residents who were not concerned and so paint the complainants as unreasonable, and the argument that the company operated under and (mostly) in compliance with its regulatory regime was a strong one, if not conclusive. Mr Dickinson
d could reasonably take the view, as I find he did, that the prospects of an eventual complete or virtually complete victory were good. This was I think more optimistic than the view of his lawyers, but I accept it was genuinely held by him. Later on I consider that his optimism strengthened, as shown by his correspondence shortly before the trial in which he seems (despite leading counsel's caveats) to have regarded the *Biffa* decision as being
e virtually a guarantee of success. That decision was successfully appealed against in March 2012 (see [2012] EWCA Civ 312, [2012] 3 All ER 380, [2013] QB 455), though it is not clear from the documents whether Mr Dickinson was aware of this; he still referred to it as a case 'lost' by Hugh James in May of that year.

[**104**] Mr Williamson and Mrs Dickinson were not involved in
f considering the potential claims with lawyers. Mr Williamson was plainly aware about the claims generally and their progress, but they did not directly affect his role in charge of purchasing and he did not participate in decision taking about them. He took his views as to prospects from Mr Dickinson, and I accept his evidence that what Mr Dickinson told him was that the company had good prospects of success. He was realistic
g enough to acknowledge that he knew there were always risks involved. Mrs Dickinson appears to have been given a rosier picture – her evidence was that her husband 'always said we are going to win'. He may have done so to reduce her concern. I accept that she believed the company would probably win.

h [**105**] Mr Dickinson was however well aware that success was not certain and that there were, at least, significant risks that the claims would succeed. Further, I am satisfied the he knew that the amounts claimed were likely to be very substantial, of the order at least of the £1.2m estimated by Weightmans in February 2009 and that costs on both sides could also amount to a high figure – the same estimate suggested a further £1.35m. By
i February 2010 CLC had told him the amounts claimed ranged up to £2.4m, excluding 'actual damage' and costs. It was not of course inevitable that even if the claims succeeded liability would be as high as that, but I am satisfied that he embarked on the various transactions now challenged in order to ensure that if the worst came to the worst he would be able to

retain control of the business and its future profit potential and that little would be available in terms of realisable assets from which an adverse judgment could be satisfied. This, I find, was not merely a substantial purpose but the dominant one in Mr Dickinson's mind.

[**106**] It was suggested that the buy-back was something that had been under consideration for many years since 2003 and the motivation for pursuing it in 2010 was to beat the budget or other possible adverse tax changes. However it is in my view clear from the contemporary documents that any previous consideration had effectively petered out by 2009, and to the extent tax risk was a factor when the idea was revived it was a subsidiary consideration – Mr Dickinson wanted to achieve his objective in the most tax efficient way, but that objective was primarily to reduce the net asset value of the company and ensure that his interests (in which I include the interests of the pension scheme and the settlement) ranked ahead of the environmental claimants. I do not accept that the buy-back would have been done in any event, even if the claim had not been in the offing.

[**107**] This is in my view the inescapable inference from the fact that the buy-back idea (and the other transactions) were embarked upon in a concentrated period just at the time when the potential claim appeared to be becoming more real and it became apparent that it was unlikely to be covered by insurance, coupled with the contemporary documents referred to above which show his concern to get control of Norton India, which he clearly at the time thought had considerable profit potential, 'in the event of a receivership', his proposal for 'Protection of Norton Aluminium/Group litigation proceedings' by transferring future profits to a new company which might 'phoenix the Norton operation' and his wish to protect the monies lent back to the company by charges, which he also discussed in terms of possible challenge in the event of a receivership.

[**108**] Mr Dickinson explained himself that the 'nub of the matter' was that he wanted to—

> 'reduce the net worth of the company by approx £2.5m … by extracting funds (which will probably be reinvested as shareholders loans secured against assets …) … I want to accomplish this in the most tax efficient manner …'

That in my view encapsulates his priorities. His aim was to reduce the company's net worth, the obvious implication in the context being that this was so that it would not be available to creditors. His objective was not, as he sought to say, to put funds in the hands of the shareholders since he repeatedly stated they would be left in the company, but by taking security to get them out of the assets available to creditors. He evidently conveyed his objective to the auditors, who produced their own suggestion for ensuring that assets and profits were transferred away from the entity facing the claim.

[**109**] Mr Dickinson maintained that these transactions were not intended to prejudice creditors, including the environmental claimants, because the company's accounts showed at all times that it had sufficient net assets to meet the anticipated maximum liability for the claim and costs. He pointed to the management accounts for May 2010 which showed net assets of about £2.7m in all, and said that the company could readily have realised about £4m in cash, because it had cash at bank at that time of about

£760,000, the ability to draw down an invoice discounting facility of £2m and could have easily sold £1.5m worth of the £1.8m of raw material stock shown in those accounts.

[110] I do not accept that this disproves the s 423 purpose, for a number of reasons:

(i) I do not accept Mr Dickinson's evidence that the company could readily have realised the amount he claimed and continued to trade without difficulty. As to stock, the company was said to be turning over £1m of stock per month (Mr Dickinson's witness statement said £2m pm). The invoice discounting facility was only drawn as to £157,000 in May 2010, but there was no question of paying any claim then. It was much more fully drawn later, presumably to assist cash flow. If as Mr Dickinson suggested the company had sold £1.5m worth of stock and fully drawn the facility, applying all the proceeds to paying the claim, I do not believe it could realistically have generated the funds to replace that stock and service its trade creditors (about £3.6m).

(ii) Nor do I believe that Mr Dickinson thought this was possible, since he consistently throughout told his own lawyers, and through them the environmental claimants, as well as the politicians and civil servants he sought to engage, that a successful claim would wipe out the company. Further, when the judgment was known, the company did not in fact consider taking these steps to raise cash and could offer only £200,000 payable within 60 days. No doubt the makeup of the balance sheet had changed in the interim but the management accounts at July 2012 still show net assets of about £3.3m, rather higher than in May 2010, cash at bank of over £1m, stock of £1.2m and over £1m of head-room in the invoice discounting facility. The fact that Mr Dickinson did not use these routes to raise cash when it was needed, and was apparently advised that the company could not offer more than the £1m it did without becoming insolvent, strongly suggest that it never could have done so.

(iii) Further, and whether or not the company could in fact have raised such amounts without causing its own collapse, I am satisfied that Mr Dickinson had no intention at any stage of doing so. This was clear just before trial when he said he had no intention of working in future for the benefit of the environmental claimants, by which he presumably meant working to pay a settlement sum off over time, but I have no doubt his attitude would have been the same or more robust if he had considered incurring debt to pay the claimants and working to repay that. I do not believe this was a recently formed intention; there is no sign at any stage of his having considered paying the claimants and whether that could be afforded. It is true he did make a provision in the accounts and considered a higher one, but this was only because he wished to set it against profits to reduce tax, not because he intended to set aside funds to meet the claim. On the contrary, he said from the outset that if the claim succeeded the company would become insolvent, and the steps he took to ensure a favourable outcome for himself in such an insolvency showed, in my judgment, that this was his intention.

[111] Converting the rights of shareholders into claims for secured debt both prejudiced the interests of the environmental claimants by increasing the pool of liabilities competing with their claim and put assets beyond their reach by ensuring that the shareholders' debt had a prior claim on the

assets. This, I find, was Mr Dickinson's dominant intention and accordingly *a*
the buy-back falls within s 423 and the court may order relief under
sub-s (2).

[112] The question was raised whether any such relief should set aside the
debentures insofar as they secure debts other than those arising under the
buy-back. There were previously amounts due to Mr Dickinson on
director's loan account, which he was keen to secure at the same time, hence *b*
his request for 'all monies' security. The buy-back, loan and security
arrangements are in my judgment to be regarded as one transaction for the
purposes of s 423, since that is how they were put in place and the purpose
I have found extends to all the steps in that composite transaction. It would
not be right to regard the granting of security as a separate transaction,
which might have been argued not to be at an undervalue (see *Re MC* *c*
Bacon Ltd (*No 2*) [1990] BCLC 607, [1991] Ch 127). If the transaction is
set aside, the security falls with it. Although the court has power to make an
order on such terms as it thinks fit, I see no reason in justice to impose a
term preserving the security for other debts. It may be true that the
company could have granted separate security for such debts without *d*
engaging s 423 but it did not do so and I see no reason to strain to preserve
some benefit in favour of the instigator of the impugned transaction.

BREACH OF FIDUCIARY DUTY

[113] I take this aspect last though it occupied the greater part of the
written and oral submissions. The liquidators' case is that in causing the *e*
company to enter into the buy-back Mr Dickinson (and the other directors
depending on their own participation) were in breach of the duty, codified
in s 172 of the Companies Act 2006, to act in the way that they consider, in
good faith, most likely to promote the success of the company, bearing in
mind the common law obligation, preserved by s 172(3), to have regard in
certain circumstances to the interests of creditors. That formulation does *f*
not clarify in what circumstances the interests of creditors are engaged, but
Mr Barker's submission was that the law was correctly set out by Mr John
Randall QC sitting as a deputy judge of the High Court in *Hellard v
Carvalho, Re HLC Environmental Projects Ltd* (*in liq*) [2013] EWHC 2876
(Ch), [2014] BCC 337 (*Re HLC Environmental*) as follows:
g

> '[88] … it is accepted that s 172 effectively codifies the pre-existing
> common law position, and that s 172(3) simply preserves the common
> law position with regard to considering or acting in the interests of
> creditors, whatever that was and is. As to the test for when these duties
> extend to the interests of creditors, this has been expressed in different
> ways in the cases: *h*
>
> (a) *"where a company is insolvent the interests of the creditors
> intrude … It is in a practical sense their assets and not the shareholders'
> assets that, through the medium of the company, are under the
> management of the directors pending either liquidation, return to
> solvency, or the imposition of some alternative administration"*: per *i*
> Street CJ (NSW) in *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 NSWLR
> 722 at 730, cited with approval by Dillon LJ in *West Mercia
> Safetywear Ltd v Dodd* [1988] BCLC 250 (CA) at 252h–253b;
>
> (b) "*where the company is insolvent, or even doubtfully solvent*": per
> Nourse LJ in *Brady v Brady* [1988] BCLC 20 (CA) at 40h–i;

(c) "*given the parlous financial state of the group, the directors had to have regard to the interests of creditors*": per Sir Richard Scott V-C in *Facia Footwear Ltd v Hinchcliffe* [1998] 1 BCLC 218 at 228f–g;

(d) "*Where a company is insolvent or of doubtful solvency or on the verge of insolvency and it is the creditors' money which is at risk*": per Mr Leslie Kosmin QC in *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd*, *Eaton Bray Ltd v Palmer* [2002] EWHC 2748 (Ch), [2003] 2 BCLC 153 at [74];

(e) "*where to the knowledge of the directors there is a real and not remote risk of insolvency, and of course the risk includes the effect of the dealing in question … the directors must consider [creditors'] interests if there is a real and not remote risk that they will be prejudiced by the dealing in question*": per Giles JA in *Kalls Enterprises Pty Ltd v Baloglow* [2007] NSWCA 191, 25 ACLC 1094 at [162].

[89] For my part, I do not detect any difference in principle behind these varying verbal formulations. It is clear that established, definite insolvency before the transaction or dealing in question is not a prerequisite for a duty to consider the interests of creditors to arise. The underlying principle is that directors are not free to take action which puts at real (as opposed to remote) risk the creditors' prospects of being paid, without first having considered their interests rather than those of the company and its shareholders. If, on the other hand, a company is going to be able to pay its creditors in any event, ex hypothesi there need be no such constraint on the directors. Exactly when the risk to creditors' interests becomes real for these purposes will ultimately have to be judged on a case by case basis. Different verbal formulations may fit more comfortably with different factual circumstances.'

[114] The risk of insolvency as a result of the claim was far from remote, Mr Barker submitted, at the time of the buy-back. There was a real risk the claim would be lost, that the resulting liability would be high and to the extent Mr Dickinson considered whether if that happened it could be paid, contrary to his case (and for the reasons given above in relation to s 423) he was well aware that an insolvency process was inevitable and that the realisable value of the assets in that process would be insufficient. The extraction of £2.5m of net assets, to Mr Dickinson's knowledge, seriously jeopardised the company's solvency and accordingly the interests of creditors were engaged.

[115] Mr Morgan's submission was that so to hold would break new ground, bringing forward to an unprecedented degree the point at which the directors have to give consideration to the interests of creditors and, arguably at least although he also submitted the cases do not yet definitively establish this, treat them as paramount. He points out that in *Re HLC Environmental* it appears the company was plainly insolvent on a balance sheet basis at all material times, and the director in question knew this (see the judgment at para [94]) so the judge did not have to consider how the principle he expressed came to be applied in practice.

[116] Some such consideration was however given in *Sequana*. The facts there were that the company faced a liability that was known to exist but uncertain in amount. The directors took detailed steps to make a proper estimate, provided for that amount and then distributed the remaining assets to members. The effect was that they ensured that if the estimate was insufficient (as it turned out to be) the company had no assets to meet the shortfall. Mr Morgan submitted that Rose J had drawn back from the apparent breadth of the principle as expressed in *Re HLC Environmental*. She said:

> '[477] To say that my house is on the verge of burning down seems to me to describe a much more worrying situation compared to one in which there is a risk which is something more than a remote risk of my house burning down. Similarly, giving the words their natural meaning, a test set at the level of "a real (as opposed) to remote risk of insolvency" would appear to set a much lower threshold than a test set at the level of being "on the verge of insolvency" or of "doubtful" or "marginal" solvency. But I agree with the conclusion of Mr Randall QC in *HLC Environmental* that the authorities appear to treat these and all the other formulations as different expressions of the same test. Having reviewed the authorities I do not accept that they establish that whenever a company is "at risk" of becoming insolvent at some indefinite point in the future, then the creditors' interests duty arises unless that risk can be described as "remote". That is not what the cases say and there is no case where, on the facts, the company could not also be accurately described in much more pessimistic terms, as actually insolvent or "on the verge of insolvency", "precarious", "in a parlous financial state" etc.
>
> [478] The essence of the test is that the directors ought in their conduct of the company's business to be anticipating the insolvency of the company because when that occurs, the creditors have a greater claim to the assets of the company than the shareholders. This case is very different from the other cases in which the triggering of the creditors' interests duty has been considered. AWA's balance sheet showed no deficit of liabilities over assets and there were no unpaid creditors knocking at AWA's door. It was not in the downward spiral of accumulating trading losses, with no income and no prospect of any income that is typical of the companies where the duty has been held to have arisen. I agree with the statement of Norris J in *Frohlich* (*Roberts v Frohlich* [2011] EWHC 257 (Ch), [2011] 2 BCLC 625 at [98]) that the underlying principle is that—
>
> "The acts which a competent director might justifiably undertake in relation to a solvent company may be wholly inappropriate in relation to a company of doubtful solvency **where a long term view is unrealistic**". (Rose J's emphasis.)
>
> [479] In the instant case, there was a real possibility that AWA would never become insolvent or even close to insolvent. The best estimate of the Fox River liability might turn out to be accurate in which case the company's assets would be sufficient to meet the liability even without the need to rely on proceeds from the Historic Insurance Policies. It cannot be right that whenever a company has on its balance sheet a provision in respect of a long term liability which might turn out to be larger than the provision made, the creditors' interests duty applies for the whole period during which there is a risk that there will be insufficient assets to meet that liability. That would result in directors having to take account of creditors' rather than shareholders' interests

when running a business over an extended period. This would be a significant inroad into the normal application of directors' duties. To hold that the creditors' interests duty arises in a situation where the directors make proper provision for a liability in the company's accounts but where there is a real risk that that provision will turn out to be inadequate would be a significant lowering of the threshold as currently described and applied in the cases to which I have referred. I can see no justification in principle for such a change.'

[117] It is true that in this case the directors, and Mr Dickinson in particular, made no real effort to estimate the potential liability and provide for it. That was principally because, according to Mr Dickinson, they took the view that the claims were unlikely to succeed and consequently it was inappropriate under the relevant accounting standard to make any provision. If so, they were somewhat inconsistent because a relatively small provision was made, with some ambiguous wording in the accounts as to whether the directors considered liability likely or not. It appears from the contemporary documents that Mr Dickinson's only concern in making this provision and fixing the amount of it was to obtain any tax deduction he could, rather than to assess the company's long term solvency.

[118] To that extent therefore the situation is different from *Sequana*. But, after some hesitation, I have concluded that Mr Morgan's submission on this issue is to be preferred, and that the authorities do not justify a finding that the general duties of directors require them to give priority to the interests of creditors simply because there is a recognised risk of adverse events that would lead to insolvency. In one sense of course the directors must always have regard to the company's liabilities – they must be satisfied in the course of its business if the business is to continue and prosper. But in ordinary circumstances this does not entail any divergence between the interests of members and creditors. It is only when some potential difference emerges that there may be a problem. This might be so if, say, the directors have to decide whether the company embarks on some long term project or investment that may benefit members in the long term, but carries risks to cash flow in the short term. If the directors must prioritise the interests of creditors, they might not be able to proceed because they must prefer short term cash flow to long term potential benefit. I would be reluctant to hold that such a situation arises where the company faces a disputed claim which, if the directors' assessment of the litigation prospects turns out to be wrong, will or may bring the company down.

[119] A more stark difference arises where the directors are considering a distribution or some uncommercial transaction that benefits themselves or members (who may be themselves or connected parties). But those transactions also engage other duties and potential remedies such as s 423, which are potentially powerful as is shown in this case and in *Sequana* itself. No doubt they do not cover every situation that a general duty in favour of creditors would, and in particular there would be an increased possibility that a transaction jeopardising creditors might be ratified by shareholder approval when such approval would be ineffective if the duty in favour of creditors was engaged, but that is not in my view sufficient to justify the potentially inhibitory effects of treating that duty as arising much earlier than the cases presently have.

[120] Assuming that the buy-back had been validly entered into, it did not

place the company on the verge of insolvency. The company was trading successfully and had ample capital and liquidity to continue to do so in the ordinary course. It had by then made a large investment in Norton India, including the loan of £1.4m, but I have no evidence to indicate there was any reason at the time to regard that as impaired. There was a real risk of insolvency if the claim was lost and resulted in a large liability, but also a real prospect that it would never become insolvent. The claims may very well have been defeated. Although the amounts sought were very high, it was not an all or nothing situation – there was a real prospect that even if some part of the claims succeeded the liability would be affordable. In that situation, the company would have been solvent in that it could have paid the liability, notwithstanding I have found that Mr Dickinson had no intention of doing so.

[121] I hold accordingly that the duty to consider the interests of creditors had not arisen, and accordingly the claim against all the directors for breach of that duty in proceeding with the buy-back fails.

TRANSFER OF THE SHARES IN NORSE CASTINGS LTD

[122] It is clear from the contemporary documents that the transfer of shares in Norse to Mr Dickinson for £1 took place not earlier than 10 February 2010 and not later than 24 February. I find it was probably on or about the latter date. In this case there was not even the pretence of a board meeting. Mr Williamson was told about the original acquisition, but only after the fact. His oral evidence was that he was not consulted about or involved in sanctioning the sale, even saying at one point he was not aware that it had been sold, though he later seemed to accept he may have been aware of the sale, but only after it happened. He had no explanation why his witness statement had said that 'the proposed [sale] consideration did not seem surprising to the board'. Mrs Dickinson did not appear to know anything about either the purchase or sale, and although aware of the existence of Norse she could not say if she became so aware at the time of the purchase or only in the course of the trial. That I think was indicative of her virtually complete lack of involvement in the company's affairs. The decisions to buy and to sell, as with all other substantive decisions, were taken by Mr Dickinson alone.

[123] The liquidators' first argument is that Mr Dickinson had no authority on behalf of the company to transfer the shares to himself so that the agreement to transfer is therefore either void, or was voidable and has been avoided by the service of the defence. Mr Barker points out that if the matter had come to the board Mr Dickinson could not have voted or been counted in the quorum by virtue of reg 84. Mr Dickinson's evidence (supported by the written evidence of the other directors) is that the other directors delegated authority to him to buy and sell companies such as Norse acting alone and on such terms as he thought fit. Further, it is pleaded in the reply that the transaction is not void or voidable because—

(i) the directors by subsequent actions (in particular but not limited to the signing of the 2010 audited accounts) informally but unanimously either approved ratified or acquiesced in the sale, or

(ii) as with the buy-back, the acts of Mr Dickinson in entering into the sale constituted the unanimous informal approval of the members. I reject that for the same reasons as I have given above. Alternatively,

(iii) Mr Dickinson dealt with the company in good faith and is entitled to the benefit of s 40 of the Companies Act 2006. That however was not pursued by Mr Morgan and is plainly wrong; by s 41(2) the effect of s 40 in the case of a transaction to which a director is party is at most that the transaction is voidable.

[124] As to delegation, there is no document setting out a decision to delegate any authority that might be referred to, to determine the existence or scope of any delegated authority. Mrs Dickinson did not participate in any meetings, let alone any decision in which delegation was considered. Neither did Mr Williamson give any evidence of consideration of such an authority. Both of them said, in slightly different terms, that it was simply left to Mr Dickinson to pursue acquisitions as he saw fit. They plainly knew that he had in the past bought other companies and capital assets from third parties and considered it was his role to do so without consulting them.

[125] It is of course common in companies small and large for authority to be delegated to employees and directors to deal with matters arising in the normal course of their duties or roles, so the absence of express consideration of the terms and of any document evidencing the authority are not fatal. But in such cases the question is what authority can be inferred to have been given from the fact the individual has been given the role and the surrounding circumstances. The court will not readily imply an unlimited authority. The limits may be imprecise; for instance they may be expressed in terms such as 'in the ordinary course of business'.

[126] In this case, while it may be appropriate to infer from the other directors' acquiescence in previous acquisitions that they impliedly authorised him to do so in future, there is nothing in the evidence to indicate that this extended to selling assets to himself. Even the most supine of directors, it seems to me, would regard this in a different light from arms length dealings with unconnected parties and something for which, if they had any thought at all for the interests of the company, they should not give a blank cheque. The court should be particularly cautious, it seems to me, in inferring authority for self-dealing given the importance attached by statute and the articles to disclosure and independent authorisation in such cases.

[127] I reject therefore the case that Mr Dickinson had implied or informal authority in advance to make the sale. Nor in my judgment was there any subsequent action, or even sufficient knowledge of the terms of the sale coupled with inaction, from which ratification or acquiescence sufficient to amount to approval can be inferred. The only specific matter referred to is the signature of the accounts, but that was only by Mr Dickinson 'on behalf of the board' and there is no evidence the others participated at all, still less that by doing so they became aware of and impliedly approved the sale. To the extent the other directors were aware of the fact of sale at all, they cannot be seen to have made any inquiry about, or even become aware of, its terms. They thus did not consider whether it could properly take place for £1 and cannot be regarded as having approved the sale willy nilly.

[128] On that ground then I hold that the sale was at best voidable and has now been avoided. The liquidators further contend that the value of

Norse was considerably more than £1 such that even if the sale had been within Mr Dickinson's authority:

(i) the shares sold constituted a 'substantial non cash asset' for the purposes of the Companies Act 2006, s 191. In the absence of approval by resolution of the members the sale is voidable (and has been avoided). Further or alternatively,

(ii) the sale was a transaction at an undervalue caught by s 423, and/or

(iii) it was in breach of fiduciary duty on the part of Mr Dickinson, and of the other directors, in their case either because they did participate and authorise it at that value or because they did not and wrongly abrogated their responsibility to Mr Dickinson.

[129] In relation to valuation, it will be recalled that Mr Dickinson said he had sold the shares with back-dated effect and that Norse still had negative net assets but was now making good profits. I am satisfied that he sought to back-date the sale so as to improve his chances of justifying the price to the tax authorities, in light of the concern expressed by the auditor in circumstances where the trading performance of Norse had improved such that it was now making good profits. It is also relevant that at the time of the sale Mr Dickinson had agreed in principle to acquire Procast, also for a nominal sum, but with the intention of merging the two operations. That purchase appears to have been negotiated on behalf of Norton Aluminium, but later took place through Norse. If so it is to be inferred that Mr Dickinson passed the opportunity on to Norse at the same time as he transferred the shares of that company to himself. If it was always intended to be a purchase by Norse, the opportunity was an asset of Norse not represented in its accounts. Mr Dickinson evidently considered it a valuable opportunity; he told his solicitor at the time 'we believe we can turn it around quite quickly' and later said in his evidence that insofar as Norse had improved its performance since acquisition that was due to the injection of £1m additional turnover from the Procast business.

[130] I had evidence from Mr Bicknell of Bloomer Heaven, who was instructed as joint expert accountant to value the shares in Norse and prepared an initial report and various supplementary responses to points put to him. He also gave oral evidence. Though he was asked to produce valuations at 30 September 2009 and in February 2010, it is the latter that is relevant since that was the time at which Mr Dickinson decided to transfer the shares.

[131] In his addendum report dated 30 January 2015 Mr Bicknell said that Norse had been reorganised and returned to profit in the 6 months to September 2009 and was at that point projected to make profits exceeding £100,000 in the following year, but that by February 2010 the position had improved further such that maintainable profits of £135,000 pa would be expected. He produced three different bases of valuation:

(i) Net assets, including goodwill valued at 2x maintainable earnings (£270,000) less an assessed deficiency of tangible assets (£50,000) giving a figure of £220,000.

(ii) Price earnings valuation based on 4x maintainable post tax earnings, less the deficiency in tangible assets – £380,000.

(iii) EBITDA valuation based on 2x EBITDA less assessed borrowings, giving a figure of £214,000.

In view of the limited information available he expressed his opinion that the 'lower' (I assume he meant lowest) value would be the most appropriate to use.

[132] A number of points were put to Mr Bicknell on both sides. Mr Dickinson's solicitors said that his evidence would be that the reorganisation involved significant time being spent at Norse by Mr Dickinson himself, who drew no remuneration from any of the companies, and his foundry manager Mr Woodward who was paid by Norton Aluminium, and invited Mr Bicknell to agree that a purchaser would take account of additional costs of £120,000 pa representing the fair value of these services, including salary and associated costs. Mr Dickinson did indeed give such evidence in his fourth witness statement, though the figures he gave are based on a charge of £60,000 for his own services and amounts for part of the costs of Mr Tranter (financial manager) as well as the foundry manager previously referred to. These were said to be based on their time spent between February 2009 and February 2010. No figures were given for any subsequent period. The costs claimed for the 3 individuals amounted to about £115,000 pa.

[133] Mr Bicknell's response was that he had not originally been given any information about these costs, the fact there had been no inter-company charge raised questions as to whether any allowance was appropriate and it was a matter for the court to find whether such costs would have been incurred in the future by a hypothetical purchaser. If costs of £120,000 were found he agreed the company would have a negative valuation. In his oral evidence he confirmed he had seen no evidence of any actual charge at any time and could not assess the quality of the services said to have been provided so as to evaluate the reasonableness of the amount claimed. He agreed with Mr Barker that Mr Dickinson had acquired a company that had not paid any charge and did not do so thereafter.

[134] I am not persuaded that it is appropriate to make any allowance for these costs. To the extent that any services were provided other than by Mr Dickinson himself it appears to have been by way of temporary secondment during the period of reorganisation. It would be expected that this would be the most intensive period of extra work, yet Mr Dickinson's case invites the assumption that services would continue to be required at the same level indefinitely thereafter. He could have, but has not, provided evidence of the extent of actual provision after February 2010, by which time the initial phase of reorganisation (prior to merging in the Procast business) appears to have been substantially achieved. Given the late emergence of the argument and the selective evidence provided, I infer that later figures would not assist his case and therefore that I should not find any substantial services were provided after February 2010.

[135] The hypothetical sale is to a reasonably well informed purchaser, and in the context of an actual sale to a connected party who has all the knowledge of the seller, the hypothetical purchaser must be assumed also to have such knowledge, ie all the actual knowledge of Mr Dickinson. Such a purchaser would not therefore assume that because turn-round work had been performed in the past it would necessarily be required thereafter. I accept that a purchaser would consider that management had to be provided, and to the extent that was no longer being given by the previous director, consider whether any cost should be deducted from earnings for it.

[136] However, the hypothetical purchaser must be taken to buy on the same terms as are offered to the actual purchaser, and as Mr Bicknell said Mr Dickinson bought a company that had not paid any such costs and did not do so thereafter. It was Mr Dickinson's choice that all the costs of the services provided were effectively borne by Norton Aluminium. In the case of actual outgoings by way of salary etc for Mr Tranter and Mr Woodman, these were paid by Norton Aluminium at all times. Even if they continued to be provided after the transfer, no charge was made and realistically in the circumstances it must be assumed that it was always Mr Dickinson's intention that this would be so. His motivation at the time, as I have found, was to reduce the assets available to the claimants in Norton Aluminium and protect wealth held elsewhere. That intention on his part is to be attributed to both sides of the hypothetical sale and so represent the terms of that sale. He cannot be heard to say that although he sold to himself on favourable terms, the value must be assessed on less favourable terms than would have been offered to an outsider.

[137] Similarly, to the extent Mr Dickinson himself provided services to Norse that was a continuation of the arrangements that had applied in the group when Norse was a part of it. He was not directly remunerated, but indirectly by salary paid to his wife and by dividends and rent paid by Norton Aluminium. It does not lie in his mouth to say he should be assumed to have changed these arrangements when he had no intention of doing so.

[138] Accordingly I make no adjustment to Mr Bicknell's figures on that account.

[139] Secondly, Mr Morgan put it to Mr Bicknell that different valuers might have different opinions as to the appropriate valuation methodology, and suggested alternative conclusions that might reasonably have been reached, in particular:

(i) In assessing maintainable profits as at February, a purchaser might look only at the figures to that date rather than including an element of projection, and reach a figure of £91,000 rather than £135,000 pa. Mr Bicknell agreed that view could have been taken, but said he felt his approach was better. Of course the question is not simply what attitude a purchaser might have taken in the hypothetical sale but what would be likely to be agreed, and the vendor, on the assumption of an arms length sale in which it is seeking the best price, would no doubt rely on its most recent and most favourable information as to future prospects.

(ii) Mr Bicknell said goodwill tended to be valued at between 1 and 3 times maintainable profits, and he had selected 2 times as a reasonable figure. He agreed another valuer might have chosen a lower figure, which he 'would not say was wrong'. I did not take him to be changing his own opinion.

(iii) In his valuation based on a price/earnings multiple, Mr Bicknell had used a multiplier of 4. Mr Morgan suggested others might have selected a figure between 2 and 3. Mr Bicknell said he 'would not rule it totally out of court'. Again, he was not changing his own opinion.

(iv) It was suggested that instead of an EBITDA multiple of 2 the appropriate figure was between 1 and 1.5. Mr Bicknell said he would not have thought the right figure was lower than 2, but agreed that he 'could see the possibility' that another valuer might choose a lower figure.

[140] Mr Morgan's overall submission, referring to *Ailyan and Fry*

(*Trustees in bankruptcy of Kevin Foster*) *v Smith* [2010] EWHC 24 (Ch), [2010] BPIR 289 and the authorities there cited was that for the purpose of assessing whether a transfer was at an undervalue the valuation of the asset in question should be taken to be the lowest of a reasonable range of possible values, and accordingly that if each of the lowest figures that Mr Bicknell had conceded were either a reasonable range or figures that another valuer might have chosen without it being able to be said that he was wrong, and if earnings were reduced by the additional costs contended for, I should find that the shares in Norse had no value at the time of transfer. Alternatively, the value might be found to be less than £100,000 such that the transaction did not fall foul of the Companies Act 2006, s 190. Finally, he submitted that if any of the claims in respect of the Norse shares were made out it would be a windfall to order that they be transferred back since they have grown in value since. The net assets of Norse were £745,000 at the date of administration and now over £1m (that would not necessarily be the value of the shares at either date, of course). His submission was that it would be appropriate to order only payment to the liquidators of the value found at the date of transfer.

[**141**] This submission is to misread what I said in *Ailyan and Fry v Smith* and *Re Thoars* (*decd*) (*No 2*), *Ramlort v Reid* [2004] EWCA Civ 800, [2005] 1 BCLC 331 on which it was based. The point there made is that it is not always necessary to find an exact value for an asset if it is clear that whatever the value is, it is substantially more than the consideration given. That is not at all the same as to say that if the court has evidence from which it may determine a value it must always do so taking every assumption or uncertainty in favour of the defendant so that the value found is the lowest possible. If the court engages in the task of finding a value it approaches such evidence, and the inherent uncertainties of valuation, in the same way as in any other case, taking account of the range of reasonable opinion and giving such weight as appears appropriate to expert opinion, which may conflict, in order to reach a conclusion.

[**142**] In this case, Mr Bicknell's own opinion was unshaken as to the most appropriate valuation figure, i e the lowest of the 3 bases he explored, being £214,000. He acknowledged the potential range of opinion, and gave his own opinion as to where in that range it would be appropriate to settle. In my view he was conservative in doing so, but I would accept his opinion and accordingly find that the value at the date of transfer was £214,000.

[**143**] I say Mr Bicknell was conservative not only because in all of his calculations he adopted, with reasons, figures that were not at the extremes of the ranges he acknowledged, and that he based his opinion on the lowest of the three bases canvassed, but also because he declined to allow any increase in value because of the availability of the opportunity to acquire Procast at the time of sale. His opinion was that because that transaction was not completed a purchaser would not be prepared to attribute any value to it. However, as I have said above, in the hypothetical arms length sale the seller must be assumed to put forward all the information it has that will assist in negotiating the best price. The purchaser is also assumed to be reasonably well informed, and in the context of a sale by an insider such as Mr Dickinson whose knowledge was effectively that of the selling company to himself, therefore to have all the information Mr Dickinson actually had. There is no reason therefore why the hypothetical purchaser's

view of the potential of the acquisition would be any different from Mr Dickinson's, and he clearly thought it likely to complete and to be of significant value.

[144] To put the matter another way, in the (highly unlikely) event that a properly acting board of the company had in fact been negotiating with an arms length purchaser to sell Norse, together with the opportunity to buy Procast but a few days before that opportunity crystallised, it is inconceivable that it would have failed to demand some additional consideration for that opportunity. It is equally inconceivable that a willing purchaser with Mr Dickinson's knowledge and opinion of the potential of that opportunity would not have been prepared to pay something extra for it. I do not seek to determine myself what that would be, but the fact that the opportunity was valuable fortifies me in my conclusion that Mr Bicknell's figure can be accepted as a conservative one.

NORSE SHARES – S 423 INSOLVENCY ACT 1986

[145] It follows that the transfer of the Norse shares was a transfer at an undervalue for the purposes of s 423. As to the statutory purpose, I am satisfied that it formed part of the overall scheme Mr Dickinson was developing to move assets out of Norton Aluminium in order that they would not be available to the environmental claimants if their claim succeeded. He discussed it at the same time and in the same context as the share buy-back, which context was shown by his references to protection of assets and future profits. It is noteworthy in particular that it was announced to the auditors in the same email as he discussed his proposals for buy-back and put forward a scheme to divert future profits from Norton itself to a Newco. It is true the last was given a different heading, but I do not believe it was a coincidence that all these matters were raised together.

[146] I do not accept that Mr Dickinson genuinely believed the shares were only worth £1, or that the true reason for the transfer was to avoid the costs of consolidating the accounts, as he asserted. His attempt to back-date the purchase to bolster the case for the valuation with Her Majesty's Revenue and Customs indicates he was well aware the value was considerably more at the true date of transfer. I have no doubt he would wish to avoid any avoidable cost, but that was a collateral matter and not his true motivation.

[147] The conditions for making an order under s 423 are therefore satisfied. The court has a wide discretion to make such order as it thinks fit for restoring the position to what it would have been if the sale had not taken place and protecting the interests of the victims of the transaction, which in this case are the creditors of Norton Aluminium. An order for payment of the true value as I have found it at the date of sale would not in my view be sufficient for those purposes. It would give the benefit of the upside potential of the transfer to the person who entered into it for his own benefit and with the aim of removing the potential from the company so as to prejudice the persons whose interests the court is to protect.

[148] Mr Barker suggested that he would be content if a line were to be drawn at the date of administration. I will in due course hear submissions as to the form of relief, but insofar as it turns on my findings under s 423 it seems to me appropriate in principle to approach the matter on the footing that but for the transfer the shares in Norse would have been assets under the control of the administrators and accordingly to make an order either that Mr Dickinson return them or that he should pay an amount equal to their value at that date, when the administrators might have sold them for the benefit of creditors.

NORSE SHARES – COMPANIES ACT 2006, S 190

[**149**] It is accepted that if I find the value of the Norse shares was more than £100,000, as I have, they constitute a 'substantial non-cash asset' as defined in the Companies Act 2006, s 191 and accordingly by s 190 the company may not make any arrangement for them to be acquired by a director without the approval of a resolution of the members.

[**150**] Mr Morgan submits such approval may be given informally by unanimous consent of the members, but that depends on the general point about Mr Dickinson's act in entering into the transaction being taken as the consent of all members. I have rejected that, and it is accepted no other approval was sought or given by members. The consequence of contravention is that the transaction is voidable (s 195) and has been avoided by service of the defence. It is not alleged that restitution is no longer possible.

NORSE SHARES – BREACH OF DUTY

[**151**] The sale of the Norse shares was pleaded to be in breach of the directors' duties to act in good faith in what they considered to be the best interests of the company, including the alleged duty to consider the interests of creditors. Since I have held that the duty to act in the interests of creditors had not arisen, the last aspect of the claim falls away. However irrespective of any separate consideration of the interests of creditors, it was plainly not in the interests of the company as a corporate entity to transfer away an asset worth £214,000 for £1 and in doing so Mr Dickinson preferred his own interests over those of the company by transferring that value to himself. In both respects he acted in breach of fiduciary duty.

[**152**] The transaction cannot be justified by saying that the company was solvent and while solvent its interests are to be considered as the same as its shareholders, since (even if that were generally the case) the transfer was to only one of those shareholders. It is not therefore to be considered as comparable to a dividend in specie.

[**153**] Since the transferee, Mr Dickinson, must be taken to have knowledge of his own breach of duty at the time of the transfer, the consequence is that the transfer is void (*GHLM Trading Ltd v Maroo* [2012] EWHC 61 (Ch), [2012] 2 BCLC 369 at [171]). If it had been merely voidable it would have been avoided by service of the defence.

NORSE SHARES – RELIEF UNDER COMPANIES ACT 2006, S 1157

[**154**] This section is potentially applicable insofar as the claim against Mr Dickinson is for breach of fiduciary duty. It is not, in my judgment, applicable insofar as he may be ordered to make restitution or compensation to the company by virtue of the setting aside or avoidance of a transaction under the Insolvency Act 1986, s 423 or the Companies Act 2006, s 195. The reason is that in those cases his liability arises because he was party to the transaction that is to be unwound, not because he is a

director. It would be illogical to have a power to grant relief in favour of a beneficiary of a transaction who happens to be an officer of the company where no such power would exist in favour of an equally honest outsider.

[155] Insofar as the section does apply, the circumstances do not in my judgment justify the grant of relief. My reasons are essentially the same as in relation to the 2005 factory transfer – Mr Dickinson did not act in what he considered to be in the interests of the company, but in his own interest to protect his wealth against the possibility of an adverse judgment. He did not seek to protect the company's interest by obtaining a valuation of the asset, but paid what he knew to be an undervalue while seeking to disguise it by back-dating the transfer.

BUY-BACK AND NORSE SHARES – POSITION OF MR WILLIAMSON AND MRS DICKINSON

[156] Neither of the other defendants played any positive role in the buy-back or the transfer of the Norse shares. Mrs Dickinson said she was told by Mr Dickinson that he intended to buy back some shares and lend the proceeds to the company, but did not know how it would work. She knew very little about it, and that came only from domestic conversations. She knew by the time she was in the witness box that the shares in Norse had been transferred, but could not say when or how she was told. It might only have been in the last few days. As I said above, she had attended no board meetings at any time, because there were none. She simply left everything to Mr Dickinson and knew only what, if anything, he chose to tell her at home. Insofar as her witness statement stated she had any greater role, it was simply untrue.

[157] Mr Williamson had been told, he thought in about March 2010, that Mr Dickinson was looking at the possibility of a share buy-back and taking advice about it. He had no further conversation about it until after it had happened, when Mr Dickinson had told him and Mr Tranter that he had taken £2.5m out of the company but that they should not worry because he had left the company solvent. He did not think this concerned him as a director, saying that Mr Dickinson was within his rights. His responsibility was buying scrap for processing. He saw the management accounts and considered the company still cash rich and so was not concerned. He thought it had been done for tax reasons. He was not consulted about the purchase or transfer of Norse shares, though found out about it afterwards. He was not concerned to inquire about it. He thought it had a negative net worth and had not been told it was making profits.

[158] Mr Barker's submission was that these directors were in breach of duty by entirely abrogating their responsibility to Mr Dickinson. He referred me to the summary of the law by Popplewell J in *Madoff Securities International Ltd* (*in liq*) *v Raven* [2013] EWHC 3147 (Comm) as follows:

> '[191] It is legitimate, and often necessary, for there to be division and delegation of responsibility for particular aspects of the management of a company. Nevertheless each individual director owes inescapable personal responsibilities. He owes duties to the company to inform himself of the company's affairs and join with his fellow directors in supervising them. It is therefore a breach of duty for a director to allow himself to be dominated, bamboozled or manipulated by a dominant

> fellow director where such involves a total abrogation of this responsibility: see *Re Westmid Packing Services Ltd, Secretary of State for Trade and Industry v Griffiths* [1998] 2 BCLC 646 at 653, [1998] 2 All ER 124; *Re Barings plc* (*No 5*) [1999] 1 BCLC 433 at 486–489; *Lexi Holdings plc v Luqman* (*No 2*) [2008] EWHC 1639 (Ch), [2008] 2 BCLC 725 at [31], [32] per Briggs J and [2009] 2 BCLC 1 at [37] per Sir Andrew Morritt C. Similarly it is the duty of each director to form an independent judgment as to whether acceding to a shareholder's request is in the best interests of the company: *Lonrho Ltd v Shell Petroleum* [1980] 1 WLR 627 at 634, 130 NLJ 605. The duty to exercise independent judgment is now reflected in s 173 of the Companies Act 2006.
>
> [192] Moreover, it has long been established that a trustee who knowingly permits a co-trustee to commit a breach of trust is also in breach of trust. A director who has knowledge of his fellow director's misapplication of company property and stands idly by, taking no steps to prevent it, will thus not only breach the duty of reasonable care and skill (which is not fiduciary in character: *Ultraframe v Fielding* [2005] EHWC 1638 (Ch) at [1300]–[1302], but will himself be treated as party to the breach of fiduciary duty by his fellow director in respect of that misapplication by having authorised or permitted it: *Walker v Stones* [2000] 4 All ER 412 at 427, [2001] QB 902 at 921; *Gidman v Barron and Moore* [2003] EWHC 153 (Ch) at [131]; *Neville v Krikorian* [2006] EWCA Civ 943, [2007] 1 BCLC 1 at [49]–[51] and *Lexi Holdings v Luqman* (*No 1*) [2007] EWHC 2652 (Ch) at [201]–[205].'

[159] In my judgment the allegation of breach of duty is in principle made out. Mrs Dickinson in truth played no role in directing or supervising the company's affairs. She took no steps to inform herself of those affairs and relied only on what her husband told her at home. To the extent she contributed anything to those discussions it was only in a domestic context as a spouse might do whether or not they held any position in the company. Mr Williamson plainly was involved to some extent in business discussions at work that went wider than his direct responsibility as an employee but that too was only to the extent that Mr Dickinson chose to discuss matters with him. He was content to go along with what I have no doubt was Mr Dickinson's way of working, which was that Mr Dickinson alone dealt with any substantial matters such as the transactions in issue here. This was not delegation with supervision, since there was no mechanism or practice of Mr Dickinson reporting to the board or seeking its approval either before or after the event, but a complete failure to engage in any responsibility. Both individuals allowed themselves to be wholly dominated by Mr Dickinson, contrary to the inescapable personal responsibilities Popplewell J referred to.

[160] Having said that, it does not automatically follow that this breach of duty was causative of any loss to the company. Insofar as the company has suffered loss the immediate cause of it is that Mr Dickinson caused it to enter into transactions for which he required, but did not obtain, the authority of the board and/or shareholders and which as a consequence were not binding on it. The fact that other directors were disengaged did not cause him to do this, nor did it in any real sense enable him to do what he did. The directors did not stand by knowing of a misapplication of company funds, since they knew little or nothing of these transactions until after they had happened. They cannot thus be made liable as parties to any such misapplication. Further, to the extent they might previously have declined to be as disengaged as they were and sought to impose some system of control on Mr Dickinson, I have little doubt he would simply have engineered their removal so that he could continue to act in the unfettered way he considered was his right. Mr Barker did not put any positive case as to what they might have done that would have led to a different outcome.

[161] I find therefore that Mr Williamson and Mrs Dickinson are not liable, notwithstanding the breach of duty by them.

[162] In case the matter goes further, had I reached the opposite conclusion I would not have granted relief to either director under the Companies Act 2006, s 1157. The circumstances in which a director is found to have been in breach of duty to act in the interests of the company but nevertheless to have acted honestly and reasonably must be rare. No dishonesty is alleged here, but it simply cannot be said that a director with an inescapable duty to join in the management of a company acted reasonably in abandoning any effective role at all in doing so.

NORTON INDIA COUNTERCLAIMS

[163] The pleaded counterclaims in relation to Norton India begin with the premise that Mr Dickinson caused the company to transfer shares to him and to the family settlement with the intention of diluting its holding and putting assets beyond the reach of creditors. In fact the evidence is that no shares were transferred, though the same effect was achieved by causing Norton India to issue further shares for cash to Mr Dickinson, which Norton Aluminium paid for on his behalf, debiting his loan account. The balance on that loan account substantially arose, of course, from the buy-back transaction. I am in no doubt that Mr Dickinson entered these arrangements as part of his overall scheme to protect assets from the potential environmental claims. He used the proceeds of the buy-back, which was entered into for that purpose, in order to create a shareholding for himself at no cost to himself. He made clear in the contemporary emails that he considered Norton India to be potentially very valuable, and that he was anxious to ensure it would not come under the control of a potential receiver of the UK company. He envisaged that a 'receiver' would be appointed if the claims were lost.

[164] At the same time, and as the emails make clear as part of the same strategy, he caused the UK company to enter into a shareholders' agreement with himself so as to give him the right to acquire the shares it held and the debt owed to it by Norton India. It appears from the evidence that he has relied on that agreement to seek transfer of those assets to him at relatively nominal values. I should say that there is no challenge before me to the validity of that agreement.

[165] Mr Barker accepts that if there was no transfer of shares by Norton Aluminium to Mr Dickinson, that part of the pleaded case falls away. What is left are allegations that the directors acted in breach of duty in causing the company to subscribe for further shares itself in Norton India at a cost of £139,000 odd at a time when it was no longer the majority shareholder, and in making further unsecured loans to that company amounting to

£750,000 odd. This was said to be preferring Mr Dickinson's interest to that of the company and its creditors, and paying away funds so that they would be out of reach of the creditors if the environmental claim succeeded.

[166] I agree however with Mr Morgan that these allegations of breach of duty cannot stand if I conclude, as I have, that the duty to consider creditors' interests had not arisen. It is not per se a breach of duty to invest in a minority shareholding or to make loans to a company in which the lender has minority holding. Further, even if I had found that interest to be engaged, there is no allegation that at the time the shares were purchased they were an uncommercial investment, or that the directors should have concluded that the loans would not be repaid. Without that it is hard to see how either amounted to any 'preference' of the interests of Mr Dickinson as another shareholder, or was not a bona fide commercial investment for the benefit of the UK company as a corporate entity interested in making a return on its own holding in Norton India.

[167] Accordingly, I reject the counterclaims relating to Norton India.

MR DICKINSON'S OWN CLAIMS

[168] I have dealt above with the validity of the debenture. The result is that any claims Mr Dickinson has are unsecured. Of those financial claims, any relating to the lease of the factory (rent and dilapidations) fall away. Claims for £11,500 paid to CLC to discharge the company's legal costs and for reimbursement of £39,690.22 paid under a personal guarantee for counsel's fees for advice to the company were agreed. A claim was made for indemnity by the company pursuant to its articles against Mr Dickinson's costs in this action, but Mr Morgan abandoned this in closing, accepting that recovery was barred by the Companies Act 2006, s 232.

[169] Of the matters addressed before me there remains a claim for £38,805.28 paid by Mr Dickinson to his own solicitors for acting in an application brought against him personally by the environmental claimants seeking a third party costs order. Article 32 of the company's articles of association provides for an indemnity to directors 'for the time being acting in relation to any affairs of the company … against any liability incurred by them to the extent permitted by the Statutes'. 'Any liability' must in the context be a liability incurred because he was 'acting in relation to [the] affairs of the company'. The personal costs claim arises out of the defence of the environmental claim, and although no doubt it will be on the basis of some aspect of his personal conduct of that claim or interest in the outcome, it has not been suggested before me that in defending the claim he was doing anything other than acting in the affairs of the company. The claim was put on the basis that he was not acting on behalf of the company in defending the costs claim made against him, but that does not advance the defendants' case – any assertion of liability against which the director seeks indemnity is bound to be a claim made against him. Further, although the Companies Act 2006, s 232 prohibits indemnity against liability for 'negligence, default, breach of duty or breach of trust in relation to the company' it has not been suggested that whatever aspect of those proceedings is said to justify a third party costs order amounts to a breach of duty to the company. Accordingly, Mr Dickinson is in my judgment entitled to indemnity against those costs.

[170] There are other debts claimed as part of the balance on director's

loan account, but it was agreed at the start of the trial that these be dealt a
with by an order for an account in the light of my findings, to the extent
they cannot be resolved by agreement.

[171] I will list a date for this judgment to be handed down. There need be no attendance on that occasion. No doubt there will be matters arising; I invite the parties to agree a time estimate for a later hearing to deal with them and submit dates of availability accordingly. b

Order accordingly.

Peter Hutchesson Barrister (NZ).

TAB 3

19-3049-cv; 19-449-cv
In re: Tribune Co. Fraudulent Conv. Litig.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

August Term 2020

(Argued: August 24, 2020 Decided: August 20, 2021)

Docket Nos. 19-3049-cv; 19-449-cv

IN RE: TRIBUNE COMPANY FRAUDULENT CONVEYANCE LITIGATION

MARC S. KIRSCHNER, AS LITIGATION TRUSTEE FOR THE TRIBUNE LITIGATION TRUST,
Plaintiff-Appellant,

- against -

LARGE SHAREHOLDERS, FINANCIAL ADVISORS, FINANCIAL INSTITUTION HOLDERS, FINANCIAL INSTITUTION CONDUITS, PENSION FUNDS, INDIVIDUAL BENEFICIAL OWNERS, MUTUAL FUNDS,
Defendants-Appellees.

MARC S. KIRSCHNER, AS LITIGATION TRUSTEE FOR THE TRIBUNE LITIGATION TRUST,
Plaintiff-Appellant,

- against -

CITIGROUP GLOBAL MARKETS INC., MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED,
Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

Before:

RAGGI and CHIN, *Circuit Judges*.*

Appeals from a judgment and orders of the United States District Court for the Southern District of New York (Sullivan and Cote, *JJ.*) dismissing claims arising out of the leveraged buyout of the Tribune Company in 2007 and its bankruptcy filing in 2008. The bankruptcy litigation trustee contends on

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* Our late colleague Judge Ralph K. Winter was originally assigned to this panel. The two remaining members of the panel, who are in agreement, have decided this case in accordance with Second Circuit Internal Operating Procedure E(b). *See* 28 U.S.C. § 46(d); *United States v. Desimone*, 140 F.3d 457, 458–59 (2d Cir. 1998).

appeal that the district court erred in dismissing his claims against the Tribune Company's shareholders and financial advisors for fraudulent transfer, breach of fiduciary duty, and related causes of action. The bankruptcy litigation trustee also contends that the district court erred in denying leave to amend his complaint.

AFFIRMED IN PART, VACATED IN PART, AND REMANDED.

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Michael S. Doluisio, Dechert LLP, Philadelphia, Pennyslvania, *for Defendants-Appellees Pension Funds, Financial Institution Holders, Individual Beneficial Owners, Mutual Funds, Certain Large Shareholders, and Financial Institution Conduits*.

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JONATHAN D. POLKES (Gregory Silbert, Stacy Nettleton, *on the brief*), Weil, Gotshal & Manges LLP, New York, New York; George E. Mastoris, Winston & Strawn LLP, New York, New York, *for Defendants-Appellees Financial Advisors*.

CHIN, *Circuit Judge*:

In 2007, the Tribune Company ("Tribune"), then-publicly traded, executed a leveraged buyout (the "LBO") to go private. Less than a year later, Tribune filed for Chapter 11 bankruptcy. Plaintiff-appellant Marc Kirschner, the bankruptcy litigation trustee (the "Trustee"), brought fraudulent conveyance and other claims on behalf of creditors against shareholders who sold their stock in the LBO and against the financial advisors that helped Tribune navigate and complete the LBO. In several orders and decisions, the district court dismissed the Trustee's claims for failure to state a claim pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure.

For the reasons set forth below, we **AFFIRM in part, VACATE in part**, and **REMAND** for further proceedings.

BACKGROUND

I. *The Facts*

The facts alleged in the operative complaints are assumed to be true for purposes of this appeal.[2]

Prior to its bankruptcy in 2008, Tribune was a media company that owned numerous radio and television stations and major national newspapers, including *The Chicago Tribune*, *The Los Angeles Times*, and *The Baltimore Sun*. In 2005, the newspaper publishing industry faced severe decline and, by 2006, Tribune, which derived approximately 75% of its total revenues from such publishing, started faltering financially. In September 2006, Tribune's board of directors (the "Board") created a special committee (the "Special Committee") to consider ways to return value to Tribune's shareholders. The Special Committee was comprised of all seven of the Board's independent directors (the "Independent Directors").

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[2] In Appeal No. 19-3049, the operative complaint is the Fifth Amended Complaint in No. 12-CV-2652, referred to by the district court as the *FitzSimons* action. In Appeal No. 19-449, the operative complaint is the First Amended Complaint in No. 12-CV-6055, referred to by the district court as the *Citigroup* action.

A. *Tribune Retains Advisors*

Before the formation of the Special Committee, the Board hired two financial advisors, defendant-appellee Merrill, Lynch, Pierce, Fenner, and Smith, Inc. ("Merrill Lynch") on October 17, 2005 and defendant-appellee Citigroup Global Markets, Inc. ("Citigroup") on October 26, 2005, to conduct a strategic review and to recommend possible responses to the ongoing changes in the media industry. Both Merrill Lynch and Citigroup signed engagement letters, which promised each a "Success Fee" of $12.5 million if a "Strategic Transaction" was completed. The engagement letters also allowed each firm to play a role in helping to finance any such "Strategic Transaction," despite the potential conflict of interest inherent in the firms' distinct roles in any such deal. The engagement letters further specified that neither Merrill Lynch nor Citigroup was a fiduciary.

On October 17, 2006, the Special Committee hired Morgan Stanley & Co. LLC f/k/a Morgan Stanley & Co. Inc. ("Morgan Stanley") to serve as its independent financial advisor. Morgan Stanley's engagement letter specified that the firm owed no fiduciary duty to Tribune.

B. *Proposed LBO*

In early 2007, Sam Zell, an investor, proposed to take Tribune private. At this time, defendants-appellees Chandler Trust No. 1, Chandler Trust No. 2, and certain Chandler sub-trusts (collectively, the "Chandler Trusts") held approximately 20% of Tribune's publicly-held shares. The Robert R. McCormick Foundation and the Cantigny Foundation (collectively, the "Foundations") held another 13% of shares. The Special Committee sought the views of the Chandler Trusts and the Foundations (together, the "Large Shareholders") on Zell's proposal. Concerned that Tribune's stock price would fall before they could sell their shares, the Large Shareholders indicated that they would only vote for a two-step LBO that allowed them to cash out during the first step. In response, Zell suggested a two-step LBO, in which, at Step One, Tribune would borrow money to buy back roughly half of its shares and, at Step Two, Tribune would borrow more money to purchase all remaining shares. Tribune would then merge with a specially created shell corporation. The new entity would become an S Corporation, resulting in nearly $1 billion in anticipated tax savings. In considering whether to approve the LBO, the Board consulted Citigroup and Merrill Lynch.

To secure financing for the LBO, Tribune needed an opinion stating that it would be solvent after each step of the proposed LBO. On February 13, 2007, the Board hired Duff & Phelps to provide such a solvency opinion. Toward that end, Tribune gave Duff & Phelps financial projections predicting that Tribune would fare better in the second half of 2007 as compared to the same period from the year prior (the "February Projections"). These figures were created by Tribune's management team, which, according to the Trustee, had a conflict of interest because its members stood to cash out Tribune shares worth $36 million and reap other gains if an LBO were executed.

After conducting its analysis, Duff & Phelps concluded it could not provide a solvency opinion without considering the $1 billion in tax savings that Tribune expected at Step Two. Duff & Phelps, however, also determined that considering such tax savings in a solvency opinion was not appropriate. Accordingly, on April 1, 2007, Duff & Phelps instead provided a "viability opinion," which concluded that the fair market value of Tribune's assets would exceed its liabilities after the close of the LBO.

The same day, Morgan Stanley and Merrill Lynch issued fairness opinions that the price to be paid for Tribune's stock was fair. These opinions were filed with the SEC as proxy statements. Also, on April 1, 2007, the Special Committee unanimously voted to recommend the two-step LBO, which the Board ultimately approved.

C. *Implementation of LBO*

Still in need of a solvency opinion to secure financing for the approved LBO, Tribune approached Houlihan Lokey, which declined, on March 29, 2007, to bid for the engagement. On April 11, 2007, Tribune retained Valuation Research Company ("VRC") to provide two solvency opinions, one for Step One and one for Step Two. To secure the engagement, VRC, "a virtually unknown firm," agreed to use a non-standard approach in formulating its solvency opinions. 3049 Appellant's Br. at 12–13.[3] VRC charged Tribune $1.5 million -- VRC's highest fee ever for such an engagement -- to issue the solvency opinions.

On May 24, 2007, VRC issued an opinion that Tribune would be solvent after completing Step One. According to the Trustee, however, after

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3 References to "3049 Appellant's Br." and "449 Appellant's Br." refer to the Trustee's briefs in Appeal Nos. 19-3049 and 19-449, respectively.

VRC issued this solvency opinion, Tribune's management team realized that the February Projections, upon which VRC's opinion was based, were no longer an accurate forecast of Tribune's 2007 second half performance. No one alerted VRC that Tribune was unlikely to meet the February Projections. Indeed, the Trustee alleges that Citigroup and Merrill Lynch reviewed VRC's solvency analysis but "failed to fulfill their responsibilities as 'gatekeepers' retained to objectively analyze the LBO." 449 Appellant's Br. at 8.

Despite the issue with VRC's solvency opinion, Tribune delivered it to the financing banks on June 4, 2007. That same day, Step One closed. Tribune borrowed $7 billion to pay off its existing bank debt and to complete a tender offer, buying back just over half of its publicly held shares. The Large Shareholders sold all their shares, and the members of the Board appointed by those shareholders resigned. After Step One, Tribune issued a proxy statement, which explained that while the LBO was in the company's best interest, it was risky and might not create the anticipated value.

In October 2007, management again updated its financial projections (the "October Projections") in preparation for Step Two. The October Projections still forecasted that Tribune's performance would improve, but not as quickly as the February Projections had predicted.

Even with the October Projections, VRC was reluctant to author a second solvency opinion because it did not appear that Tribune would be able to repay its debts without refinancing its existing debts. Tribune management represented to VRC that Morgan Stanley -- the Special Committee's financial advisor -- believed that Tribune would be able to refinance its debts, even though Morgan Stanley had not drawn that conclusion. On December 18, 2007, VRC issued a solvency opinion stating that Tribune would be solvent after Step Two.

The Board's retained financial advisors did not agree with VRC's second solvency opinion. In fact, analyses from Citigroup and Merrill Lynch showed that, at the close of Step Two, Tribune would be insolvent by more than $1.4 billion and $1.5 billion respectively, but neither advisor tried to stop the transaction. On December 20, 2007, Step Two closed, and Tribune borrowed an additional $3.7 billion, which it used to buy back its remaining publicly held shares.

After the close of Step Two, Tribune had roughly $13 billion in debt. Tribune's directors and officers received approximately $107 million from selling their stock and from bonuses. Citigroup and Merrill Lynch were each paid their $12.5 million success fee because they helped effectuate a "Strategic Transaction." A group of pension funds (the "Pension Funds"), who are defendants-appellees in this case, also received cash proceeds in connection with the LBO.

II. *Procedural History*

On December 8, 2008 -- less than one year after Step Two closed -- Tribune filed for Chapter 11 bankruptcy in Delaware. Claims were eventually filed in the Delaware Bankruptcy Court on behalf of creditors, including for fraudulent conveyance. Tribune emerged from bankruptcy in 2012; pursuant to Tribune's plan of reorganization, the claims were transferred to the Tribune Litigation Trust, and the Trustee was appointed to pursue the claims on behalf of Tribune's creditors.

In the meantime, some seventy-four federal and state lawsuits asserting fraudulent conveyance and related claims were filed around the country by Tribune's creditors. Eventually, the Judicial Panel on Multidistrict Litigation transferred the bankruptcy claims as well as the federal and state actions to the Southern District of New York, where they were consolidated on the basis that the claims all arose out of the LBO and Tribune's 2008 Chapter 11 bankruptcy filing. *See In re: Tribune Co. Fraudulent Conv. Litig.*, 831 F. Supp. 2d 1371, 1372 (J.P.M.L. 2011).

On September 23, 2013, the district court (Sullivan, *J.*) dismissed several state law constructive fraudulent conveyance claims that were brought against Tribune. The parties appealed, and on March 29, 2016, this Court affirmed the district court's dismissal of the state law fraudulent conveyance claims. *See In re Tribune Co. Fraudulent Conv. Litig.*, 818 F.3d 98, 105 (2d Cir. 2016) ("*Tribune I*"). After further proceedings in this Court and the Supreme Court, we issued an amended opinion on December 19, 2019, affirming the district court's dismissal of the state law constructive fraudulent conveyance claims on the basis that these claims were preempted by section 546(e) of the Bankruptcy Code, which provides that a trustee may not avoid a transfer made by or to a "financial institution" in connection with "a securities contract." *In re Tribune Co. Fraudulent Conv. Litig.*, 946 F.3d 66, 78, 96 (2d Cir. 2019) ("*Tribune II*").[4]

[4] On July 22, 2016, this Court denied rehearing *en banc*, and our mandate issued on August 1, 2016. On September 9, 2016, the Trustee petitioned for certiorari to the Supreme Court. In April 2018, the Supreme Court advised the parties that their petition

In the meantime, the district court proceeded to consider defendants' motions to dismiss the remaining claims. On January 6, 2017, the district court (Sullivan, *J.*) dismissed the Trustee's intentional fraudulent conveyance claims with prejudice because it found that the complaint failed to allege that Tribune had the actual intent to defraud its creditors when it bought back shares from shareholders at both steps of the LBO. In particular, the district court concluded that the intent of the Tribune officers who created the February and October Projections could not be attributed to the Special Committee, which approved the LBO. The district court also declined to grant the Trustee leave to amend its complaint in the *FitzSimons* action, "without prejudice to renewal in the event of an intervening change in the law." 3049 S. App'x at 28.

On November 30, 2018, the district court (Sullivan, *J.*) dismissed the Trustee's state law claims for breach of fiduciary duty asserted in the *FitzSimons*

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for certiorari as to *Tribune I* would be deferred to allow this Court to consider whether to recall the mandate in light of the Supreme Court's decision in *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, 138 S. Ct. 883, 892 (2018), which held, *inter alia*, that Section 546(e) does not protect transfers in which financial institutions served as mere conduits. *See Deutsche Bank Tr. Co. Americas v. Robert R. McCormick Found.*, 138 S. Ct. 1162, 1163 (2018) (statement of Justices Kennedy and Thomas). As a result, this Court recalled its mandate and eventually issued *Tribune II*.

Complaint and certain "tag-along" actions. In particular, the district court declined to collapse the two-step LBO into a unitary transaction, thereby concluding that (1) Tribune was solvent at Step One, and (2) the Large Shareholders were not liable at Step Two because they had relinquished their board seats and Tribune stock by that point.

On December 1, 2018, the case was reassigned to Judge Cote. On January 23, 2019, the district court (Cote, *J.*) granted Citigroup and Merrill Lynch's motions to dismiss certain claims in the *FitzSimons* and *Citigroup* actions. As relevant here, the district court dismissed the aiding-and-abetting and professional malpractice claims under the *in pari delicto* doctrine and it dismissed the fraudulent conveyance claims on the ground that the advisory fees received did not constitute actual or constructive fraudulent conveyances. On April 23, 2019, the district court denied the Trustee's request to amend his complaint in the *FitzSimons* action, denying leave to file what would have been a Sixth Amended Complaint.

These appeals followed.

DISCUSSION

Three categories of claims are at issue: (1) intentional fraudulent conveyance claims against the shareholders based on the buy-back of their shares; (2) breach of fiduciary duty and aiding and abetting breach of fiduciary claims against the allegedly controlling shareholders; and (3) aiding and abetting breach of fiduciary duty, professional malpractice, intentional fraudulent conveyance, and constructive fraudulent conveyance claims against Citigroup, Merrill Lynch, Morgan Stanley, and VRC (collectively, the "Financial Advisors"). We discuss these claims in turn, as well as the district court's denial of leave to amend.

We review *de novo* a district court's grant of a motion to dismiss under Rule 12(b)(6) for failure to state a claim, "accepting the complaint's factual allegations as true and drawing all reasonable inferences in the plaintiff's favor." *Carpenters Pension Tr. Fund of St. Louis v. Barclays PLC*, 750 F.3d 227, 232 (2d Cir. 2014) (internal quotation marks omitted). "We review the district court's denial of leave to amend for abuse of discretion." *Broidy Cap. Mgmt. LLC v. Benomar*, 944 F.3d 436, 447 (2d Cir. 2019) (internal quotation marks omitted). If, however, "the denial was based on futility, . . . we review that legal conclusion *de novo*." *City of*

Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG, 752 F.3d 173, 188 (2d Cir. 2014).

I. *Intentional Fraudulent Conveyance Claims*

We first consider whether the district court erred in dismissing the Trustee's intentional fraudulent transfer claims against the shareholders based on the buy-back of their shares.

A. *Applicable Law*

The Bankruptcy Code allows a bankruptcy trustee to recover fraudulent transfers where a transfer has been made with "actual intent to hinder, delay, or defraud" creditors. 11 U.S.C. § 548(a)(1)(A). An intentional fraudulent conveyance claim must be pled with specificity, as required by Fed. R. Civ. P. 9(b). *See In re Sharp Int'l Corp.*, 403 F.3d 43, 56 (2d Cir. 2005). The alleged fraud must relate to the specific payment or transfer the plaintiff is seeking to avoid, rather than to the overall course of business. *See id.* (differentiating between alleged fraud in obtaining funding from noteholders and subsequent payment of some proceeds to defendant). And by "actual intent," the statute contemplates intent "existing in fact or reality" and not merely the imputed intent that would suffice for a constructive fraudulent conveyance claim. *Intel Corp.*

Inv. Pol'y Comm. v. Sulyma, 140 S. Ct. 768, 776 (2020) (holding, in context of ERISA, that "actual" means "existing in fact or reality," more than "potential, possible, virtual, conceivable, theoretical, hypothetical, or nominal") (citations and internal quotation marks omitted); *compare* 11 U.S.C. § 548(a)(1)(A) (intentional fraudulent conveyance) *with id.* § 548(a)(1)(B) (constructive fraudulent conveyance); *see also United States v. Finkelstein*, 229 F.3d 90, 95 (2d Cir. 2000) ("[T]he should-have-known alternative connotes a concept more akin to negligence than to knowledge.").

Because of the difficulties in proving intent to defraud, a pleader may rely on "badges of fraud," *i.e.*, circumstances so commonly associated with fraudulent transfers that their presence gives rise to an inference of intent. *In re Kaiser*, 722 F.2d 1574, 1582 (2d Cir. 1983). Courts have inferred intent to defraud from the "concealment of facts and false pretenses by the transferor," "reservation by [the transferor] of rights in the transferred property," the transferor's "absconding with or secreting the proceeds of the transfer immediately after their receipt," "the existence of an unconscionable discrepancy between the value of property transferred and the consideration received therefor," the oppressed debtor's creation "of a closely-held corporation to receive the transfer of his property," as well as the oppressed debtor's transfer of property while insolvent. *Id.* (citation omitted); *see also Sharp*, 403 F.3d at 56.

A corporation can only act through its directors and officers, and we look to state law to determine who has the authority to act on behalf of a corporation (and therefore whose actions to review to see whether there was fraudulent intent or badges of fraud). *See Burks v. Lasker*, 441 U.S. 471, 478 (1979) ("[T]he first place one must look to determine the powers of corporate directors is in the relevant State's corporation law."). Under Delaware law -- Tribune's state of incorporation -- only the board of directors (or a committee to which the board has delegated its authority) has the power to approve an extraordinary transaction such as a merger or consolidation. *See* Del. Gen. Corp. Law §§ 141(a), (c), 160(a), 251(b). Here, the Board delegated its authority to approve a merger and redemption of Tribune's stock to the Special Committee, and thus the Trustee was required to plead allegations that gave rise to a strong inference that the Special Committee had the "actual intent to hinder, delay, or defraud" Tribune's creditors, as required by 11 U.S.C. § 548(a)(1)(A).

The Trustee does not argue that the members of the Special Committee had "actual intent" to harm Tribune's creditors but instead contends that Tribune's senior management had the necessary fraudulent intent, and that this intent must be imputed to the Special Committee. The issue of whether a company's officers' intent to defraud creditors can be imputed to an independent special committee for purposes of a fraudulent conveyance claim under the Bankruptcy Code is a question of first impression in this Circuit. The First Circuit has addressed the issue and applied a "control" test -- a court "may impute any fraudulent intent of [an actor] to the transferor . . . [if the actor] was in a position to control the disposition of [the transferor's] property." *In re Roco Corp.*, 701 F.2d 978, 984 (1st Cir. 1983). The district court here applied the control test, holding that "this test appropriately accounts for the distinct roles played by directors and officers under corporate law, while also factoring in the power certain officers and other actors may exercise over the corporation's decision to consummate a transaction." 3049 S. App'x at 9.

The Trustee argues that the district court erred in applying the control test, and that the correct standard is either a scope-of-employment agency standard or a "proximate cause" standard. We are not persuaded. In the circumstances here, we affirm the district court's use of a "control" test for imputation. We agree that for an intentional fraudulent transfer claim, which requires "actual intent," a company's intent may be established only through the "actual intent" of the individuals "in a position to control the disposition of [the transferor's] property." *Roco*, 701 F.2d at 984; *see also In re Lehman Bros. Holdings, Inc.*, 541 B.R. 551, 576 (S.D.N.Y. 2015) ("[T]he Court's analysis regarding imputation must turn on *actual control* of [the debtor].").[5]

B. ***Application***

The Trustee makes two arguments in support of his intentional fraudulent transfer claims. First, he argues that Tribune's senior management possessed actual intent to defraud, and that intent should be imputed to the Special Committee. Second, even assuming the imputation argument fails, the Trustee maintains that Independent Directors on the Special Committee had the required intent as demonstrated by "badges of fraud."

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5 In arguing for a lesser imputation standard, the Trustee relies heavily on *Staub v. Proctor Hospital*, 562 U.S. 411 (2011). That case, however, applied a "motivating factor" standard under the Uniformed Services Employment and Reemployment Rights Act, *id.* at 417–18, and we are not persuaded that it carries much weight in a case requiring "actual intent" under the Bankruptcy Code.

1. *Imputation of Intent*

We conclude that the Trustee failed to plausibly allege that the intent of Tribune's senior management should be imputed to the Special Committee because the Trustee failed to allege that Tribune's senior management controlled the transfer of the property in question.

As discussed above, the Board created an independent Special Committee to evaluate the LBO. The Special Committee, in turn, hired Morgan Stanley to serve as its independent financial advisor. As the district court observed, the Trustee failed to allege that senior management inappropriately pressured the Independent Directors -- who included former senior officers of major corporations -- to approve the transactions or that senior management dominated the Special Committee.

The Trustee failed to allege any financial or personal ties between senior management and the Independent Directors that could have affected the impartiality of the Special Committee. And to the extent that the officers misled the Special Committee by presenting it with the February Projections and a flawed viability and solvency opinions, Morgan Stanley and the Special Committee itself checked these figures. Therefore, to impute the officers' intent onto the Special Committee, which was working independently with an outside financial advisor and independently reviewed opinions provided by Duff & Phelps and VRC, would stretch the "actual intent" requirement as set forth in § 548(a)(1)(A) to include the merely possible or conceivable or hypothetical as opposed to existing in fact and reality.

2. *The Badges of Fraud*

On appeal, the Trustee contends that five of the traditional "badges of fraud" weigh in favor of finding actual intent -- (1) lack of consideration for the shareholder transfers; (2) Tribune's financial condition; (3) the relationship among the parties; (4) the "pattern of transactions"; and (5) the "general chronology" of the events. 3049 Appellant's Br. at 37–38. While some of these factors arguably weigh in favor of the Trustee, in the end we conclude that the district court correctly held that the Trustee failed to plead "badges of fraud" sufficient to raise a strong inference of actual fraudulent intent on the part of the Special Committee. *See Kaiser*, 722 F.2d at 1582–83.

The Trustee's assertion that Independent Directors stood to earn $6 million for selling their shares if they approved the LBO is insufficient to satisfy the stringent pleading standard of Rule 9(b). First, it would be unreasonable to assume actual fraudulent intent whenever the members of a board of directors (or a committee created by that board) stood to profit from a transaction they recommended or approved. *See, e.g.*, *Kalnit v. Eichler*, 264 F.3d 131, 139 (2d Cir. 2001) ("Motives that are generally possessed by most corporate directors and officers do not suffice [to demonstrate fraud]. . . . Insufficient motives, we have held, can include (1) the desire for the corporation to appear profitable and (2) the desire to keep stock prices high to increase officer compensation."). Second, the Independent Directors owned only a small fraction (0.08%) of Tribune's shares, and the Independent Directors' shares were sold at a price only slightly above the price at which Tribune stock had been trading. These assertions, even assuming they are true, do not give rise to a strong inference of actual fraudulent intent.

The Trustee's arguments that the Independent Directors "knew that Tribune was falling far short of projections and thus was unlikely to generate enough cash to service its debt" and the risky nature of the proposed LBO were indications of fraud are also unpersuasive. 3049 Appellant's Br. at 38. Even assuming the Independent Directors were wrong in believing that Tribune's financial condition would improve, their approval of a risky transaction when

Tribune and other newspaper companies were struggling would arguably support a negligence or constructive fraud claim but not, in the circumstances here, an intentional fraudulent transfer claim. *See, e.g., In re Lehman Bros. Holdings, Inc.*, 541 B.R. at 577 ("Indeed, there is nothing unlawful about a company transacting business during unusually difficult financial times in an attempt to prevent its own collapse. To find otherwise would place in question any contract executed during a financial downturn and invite upheaval in the financial markets."). Moreover, Tribune's contemporaneous public filings warned that its projections could fall short, and the Independent Directors had an obligation to try to achieve the highest price for Tribune's shareholders. *See, e.g., Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) (directors have duty to obtain highest price for shareholders).

Again, the Trustee was required to plausibly allege *actual* fraudulent intent on the part of the members of the Special Committee. We agree with the district court that the Trustee failed to do so.

II. *State Law Fiduciary Duty Claims*

We next consider the Trustee's claims that the Large Shareholders breached their fiduciary duties under Delaware law by pushing for the LBO based on projections they knew to be false and by causing Tribune to incur debt they knew would leave the company insolvent. The Trustee also alleges that through this conduct the Large Shareholders aided and abetted senior management's own breach of fiduciary duty and were unjustly enriched. The Trustee argues that Steps One and Two of the LBO should be collapsed so that the LBO is viewed as a single unitary transaction. The Trustee contends that, if the LBO is so viewed and Tribune's Step Two obligations taken into account at the start, Tribune was insolvent as of April 1, 2007, the day that Tribune's Board originally voted to approve the LBO. The Trustee alleges that the Large Shareholders were controlling shareholders with attendant fiduciary duties before Step One and that these fiduciary duties were breached by advocating for and executing the LBO.

The district court dismissed Trustee's claims, holding that Steps One and Two could not be collapsed into a unitary transaction and that Tribune's purported insolvency had to be analyzed separately at each of the LBO's two steps. The district court concluded that the Trustee's allegations failed at Step One because he could not plausibly allege that Tribune was insolvent at that point. While the district court concluded that the Trustee had adequately pleaded Tribune's insolvency at Step Two, it held that the fiduciary duty claims nevertheless failed because, after Step One, the Large Shareholders no longer owned any Tribune stock and their appointed directors had resigned from the Board.

The principal issue with respect to these claims is thus whether the Trustee's pleadings support collapsing Step One and Step Two into one event.

A. *Applicable Law*

Under Delaware law, a shareholder owes the company a fiduciary duty "only if it owns a majority interest in or exercises control over the business affairs of the corporation." *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987). If such a fiduciary duty exists, a shareholder breaches that duty if, for its own benefit, it approves a transaction that renders the corporation insolvent. *See, e.g.*, *In re Tropicana Entm't, LLC*, 520 B.R. 455, 471 (Bankr. D. Del. 2014) (holding that creditor must allege either that corporation was or became insolvent as result of fiduciary's misconduct to bring suit for breach of fiduciary duty); *see also Crawford v. Franklin Credit Mgmt. Corp.*, 758 F.3d 473, 482 (2d Cir.

2014) (noting this Court may "affirm the judgment on any basis that is supported by the record").[6]

To determine whether the two steps should be viewed as a single transaction, the district court applied the *Sabine* factors, which consider (i) "[w]hether all of the parties involved had knowledge of the multiple transactions"; (ii) "[w]hether each transaction would have occurred on its own"; and (iii) "[w]hether each transaction was dependent or conditioned on other transactions." *In re Sabine Oil & Gas Corp.*, 547 B.R. 503, 541 (Bankr. S.D.N.Y.), *aff'd*, 562 B.R. 211 (S.D.N.Y. 2016).

In performing this analysis, Delaware courts have sometimes applied a "step-transaction doctrine," under which collapse is warranted if a party can satisfy any one of three tests: (1) the "end result test," which authorizes collapse "if it appears that a series of separate transactions were prearranged

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[6] We assume, without deciding, that the Large Shareholders had a fiduciary duty to Tribune. We note, however, that together the Chandler Trusts and the Foundations owned only 33% of Tribune's publicly held shares. *See Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1114 (Del. 1994) ("[A] shareholder who owns less than 50% of a corporation's outstanding stocks does not, without more, become a controlling shareholder of that corporation, with a concomitant fiduciary status." (quoting *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 70 (Del. 1989)).

parts of what was a single transaction, cast from the outset to achieve the ultimate result"; (2) the "interdependence test," which authorizes collapse if "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series"; and (3) the "binding-commitment test," which allows collapse "only if, at the time the first step is entered into, there was a binding commitment to undertake the later steps." *Bank of N.Y. Mellon Tr. Co. v. Liberty Media Corp.*, 29 A.3d 225, 240 (Del. 2011) (internal quotation marks omitted).

Delaware courts have also noted that, regardless of the test to be applied, the substance of the transaction is what matters, not the form. *See Gatz v. Ponsoldt*, 925 A.2d 1265, 1280 (Del. 2007). Further, they have noted that "courts have found that a set of transactions may be viewed as one integrated transaction if the transactions reasonably collapse into a single integrated plan and either defraud creditors or leave the debtor with less than equivalent value post-exchange." *In re Hechinger Inv. Co. of Del.*, 274 B.R. 71, 91 (D. Del. 2002) (internal quotation marks omitted). In *Hechinger*, the court denied a motion to dismiss and noted that it was "reluctant to conclude that because the defendants structured the set of transactions in a certain manner, they [were] immune from a claim of breach of fiduciary duty, especially where the [complaint] allege[d] that the harms it complain[ed] of were foreseeable results of the acts of the defendants." *Id.*

B. ***Application***

1. ***Was the LBO a Unitary Transaction?***

Although we must accept as true all plausible allegations set forth in the complaint, we need not accept "threadbare recitals of a cause of action's elements" that are "supported by mere conclusory statements." *Ashcroft v. Iqbal*, 556 U.S. 662, 663 (2009). Here, the Trustee failed to sufficiently allege that the two steps should be collapsed into one.

First, it is undisputed that there were several obstacles that Tribune needed to clear after Step One and before completing Step Two. At Step One, Tribune borrowed approximately $7 billion and executed a tender offer, by which the company repurchased half of Tribune's outstanding common stock and refinanced its existing debt. Even if Step Two were never consummated, Step One would have amounted to a standalone recapitalization plan -- similar to transactions Tribune had engaged in prior to the LBO.[7]

Additionally, the "knowledge and intent of the parties" weigh heavily against the Trustee's collapse argument as neither Tribune nor the Large Shareholders knew for certain whether both steps would be completed. Step Two required shareholder approval, which was not received until months after Step One closed, and the Trustee does not allege that the Large Shareholders had anything to do with the "pie-in-the-sky" February Projections. 3049 J. App'x at 146–47. Similarly, Tribune never knew that Step Two was a foregone conclusion, as its merger would need government approval.

Further, the complaint acknowledges that there were several additional hurdles Tribune had to clear to effectuate Step Two, including receiving a solvency opinion, and that the Large Shareholders were concerned that the deal would not actually close. Indeed, Tribune's July 13, 2007 proxy statement warned that there was a "risk that the conditions to the [Step Two]

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[7] In May 2006, Tribune engaged in a leveraged recapitalization by which it purchased 55 million shares of outstanding stock for $1.8 billion in May 2006. In March 2007, Tribune again considered a "more modest recapitalization plan." 3049 J. App'x at 198.

Merger will not be met, including the conditions requiring receipt of FCC approval, the receipt of financing and receipt of a solvency opinion." 3049 J. App'x at 1740. Finally, as the Large Shareholders point out, the two-step transaction was designed to guard against the possibility that the second step might not close if conditions precedent were not satisfied. The Trustee even acknowledges that the LBO was structured in two steps *because* the Board "express[ed] concerns regarding the delays and completion risk associated with Zell's [initial single-step] proposal." 3049 J. App'x at 191. Therefore, the Board decided instead on the two-step LBO to "provide an upfront distribution to Tribune's stockholders," even if Step Two were never consummated. *Id*.

The parties do not dispute that *Sabine* applies federally, though ultimately we conclude that, regardless of whether *Sabine* or Delaware's "step-transaction doctrine" applies, the two steps of this LBO should not be collapsed. As the facts alleged in the complaint make clear, the third *Sabine* factor weighs against collapse. Further, collapse is inappropriate under all three of the step-transaction tests, because the parties intended to structure the two steps as independent transactions, Step One was able to stand alone, and there was no binding commitment to undertake Step Two. Accordingly, we affirm the district court's conclusion that the two steps must be considered independently.

2. *Was Tribune Insolvent at Step One?*

The Trustee argues that even if the two steps are not treated as a unitary transaction, he sufficiently alleged Tribune's insolvency at Step One, to support a claim that the Large Shareholders breached their fiduciary duties when approving of a transaction that resulted in insolvency. The district court held that the Trustee failed to sufficiently allege that Tribune was insolvent at Step One of the LBO under either the "balance sheet" or the "inability to pay debt when due" tests. We agree.

In Delaware, "[u]nder the balance sheet test, an entity is insolvent if it has liabilities in excess of a reasonable market value of assets held." *Quadrant Structured Prods. Co. v. Vertin*, 102 A.3d 155, 176 (Del. Ch. 2014) (internal quotation marks omitted). We are not persuaded by the Trustee's argument that the district court erred in failing to take into account "the commitments Tribune had *already* made -- notably to borrow an additional $3.7 billion of debt and to make an additional $4 billion distribution to its shareholders -- for which performance was due at Step Two." 3049 Appellant's Br. at 65. This argument rests on the same logic undergirding the Trustee's argument in favor of collapsing the two steps, which we have rejected for the reasons outlined above. Moreover, the Trustee himself admits that he "did not allege that the $8 billion borrowed at Step One, standing alone, rendered Tribune insolvent." *Id.* at 62.

As to the "inability to pay debts when due" test, the Trustee's argument again hinges upon his assertion that the district court should have considered whether Tribune was able to pay upcoming debts or raise additional capital in the future -- *i.e.*, by taking "Step Two into account, along with Tribune's ability to access additional funds." *Id.* at 70. In other words, the Trustee argues that courts should not limit their consideration to past debt payments and instead also consider whether companies will be able to pay upcoming debts or raise additional capital in the future.

There appears to be no consensus in Delaware courts, however, as to whether this test is forward-looking. *See, e.g.*, Robert J. Stearn, Jr. & Cory D. Kandestin, *Delaware's Solvency Test: What Is It and Does It Make Sense? A Comparison of Solvency Tests Under the Bankruptcy Code and Delaware Law*, 36 Del. J. Corp. L. 165, 182 (2011) ("The [inability to pay debts when due] test is not entirely clear: the unanswered question is whether the test is present or forward-looking.

. . . The case law does not answer this question definitively."). The Trustee cites several Delaware cases, *see* 3049 Appellant's Br. at 69, but they are inapposite as none definitively establishes that courts *must* consider future debts to be incurred as part of its insolvency analysis. Moreover, as the district court observed, this Court offered a definitive answer in *Pereira v. Farace*, 413 F.3d 330 (2d Cir. 2005). There, we rejected a forward-looking approach, noting that such a test would "project[] into the future to determine whether capital will remain adequate over time while the Delaware [inability to pay debts when due] test looks solely at whether the corporation has been paying bills on a timely basis." *Id*. at 343. We see no reason to overturn that holding here.

Accordingly, we conclude that the district court did not err in dismissing the Trustee's state law claims against the Large Shareholders. We additionally conclude that the district court did not abuse its discretion in dismissing these claims with prejudice, as the Trustee has not explained what specific facts he would plead to salvage these claims.

III. *Claims Against Financial Advisors*

We next consider whether the district court erred in dismissing the following claims against the Financial Advisors: (1) aiding and abetting breaches of fiduciary duty and professional malpractice[8]; (2) intentional fraudulent conveyance; and (3) constructive fraudulent conveyance. For the reasons set forth below, we affirm the district court's dismissal of the aiding and abetting and professional malpractice claims as to all Financial Advisors; we affirm the district court's dismissal of the intentional fraudulent conveyance claims as to Morgan Stanley, Citigroup, and Merrill Lynch, and vacate the dismissal of these claims as to VRC; and we affirm the dismissal of the constructive fraudulent conveyance claims as to Morgan Stanley and VRC and vacate the dismissal of these claims as to Citigroup and Merrill Lynch.

A. *Aiding and Abetting Breach of Fiduciary Duty and Professional Malpractice Claims*

1. *Applicable Law*

Under Delaware law,[9] a third party may be liable for aiding and abetting a breach of fiduciary duty if there is "(i) the existence of a fiduciary

[8] Additionally, the Trustee asserted a breach of fiduciary claim, but against only Morgan Stanley. The district court did not explicitly address this claim in its January 23, 2019 opinion. In a February 13, 2019 order, however, the district court stated that this claim was "barred for the same reasons discussed in the January 23 Opinion with respect to the other common law claims asserted against Morgan Stanley . . . namely, the doctrine of *in pari delicto*." 3049 S. App'x at 180.

[9] The parties agree that Delaware law governs the Trustee's aiding and abetting claim.

relationship, (ii) a breach of the fiduciary's duty, (iii) knowing participation in that breach by the defendants, and (iv) damages proximately caused by the breach." *RBC Cap. Mkts., LLC v. Jervis*, 129 A.3d 816, 861 (Del. 2015).

The *in pari delicto* doctrine acts as an affirmative defense to an aiding and abetting claim by barring a plaintiff "from recovering damages if his losses are substantially caused by activities the law forbade him to engage in." *Stewart v. Wilmington Tr. SP Servs., Inc.*, 112 A.3d 271, 301–02 (Del. Ch.), *aff'd*, 126 A.3d 1115 (Del. 2015) (internal quotation marks omitted). In other words, a plaintiff can generally only sue for aiding and abetting a breach of fiduciary duty if the plaintiff's hands are clean. As applied to corporations, the illegal actions of a corporation's officers and directors are imputed to the corporation itself. *Id.* at 303. There are, however, exceptions that render the *in pari delicto* doctrine inapplicable and therefore permit a plaintiff to sue, even if its hands are not clean.

First, under the adverse interest exception, a corporation is permitted to sue those alleged to have aided an agent's wrongdoing when "the corporate agent responsible for the wrongdoing was acting *solely* to advance his own personal financial interest, rather than that of the corporation itself." *In re*

Am. Int'l Grp., Inc., Consol. Derivative Litig., 976 A.2d 872, 891 (Del. Ch. 2009) ("*AIG II*"), *aff'd sub nom. Teachers' Ret. Sys. of La. v. Gen. Re Corp.*, 11 A.3d 228 (Del. 2010) (emphasis added). The adverse interest exception, however, does not enable a plaintiff to recover if the wrongdoing benefits the corporation. *Stewart*, 112 A.3d at 309.

Further, the exception does "not apply even when the 'benefit' enjoyed by the corporation is ultimately outweighed by the long-term damage that is done when the agent's mischief comes to light"; instead, it only covers the "unusual" case where allegations support a reasonable inference of "total abandonment of the corporation's interests." *Id.* at 303, 309 (describing "siphoning corporate funds or other outright theft" as such "unusual" cases); *see also In re Am. Int'l Grp., Inc.*, 965 A.2d 763, 827 (Del. Ch. 2009) ("*AIG I*") (holding that the adverse interest test is directed at insiders who are "essentially stealing from the corporation as opposed to engaging in improper acts that, even if also self-interested, have the effect of benefiting the corporation financially"), *aff'd sub nom. Teachers' Ret. Sys. of La. v. PricewaterhouseCoopers LLP*, 11 A.3d 228 (Del. 2011).

Second, the fiduciary/insider exception to the *in pari delicto* doctrine allows a suit to be brought against corporate fiduciaries who "knowingly caused the corporation to commit illegal acts and, as a result, caused the corporation to suffer harm." *AIG II*, 976 A.2d at 889. The *AIG II* court appeared, on public policy grounds, to limit the application of the fiduciary exception to "gatekeepers," third parties employed by a corporation to help ensure the lawful operation of the corporation. *Id.* at 890 n.49, 892–93; *see also RBC Cap. Mkts.*, 129 A.3d at 865 n.191 (rejecting the proposition that financial advisors are inherently "gatekeepers," explaining that "the role of a financial advisor is primarily contractual in nature" and defined by its engagement letter). Similarly, the fiduciary exception precludes application of the *in pari delicto* doctrine to aiding and abetting claims against "non-fiduciaries . . . who occupy a position of trust and materially participate in the traditional insiders' discharge of their fiduciary duties." *Stewart*, 112 A.3d at 320 (holding that the auditor defendants played a "gatekeeper" role).

The *in pari delicto* doctrine also applies to the Trustee's professional malpractice claims. Under both New York law and Illinois law,[10] professional malpractice claims are viewed as a species of negligence. *See Hydro Invs., Inc. v. Trafalgar Power Inc.*, 227 F.3d 8, 15 (2d Cir. 2000); *Hassebrock v. Bernhoft*, 815 F.3d 334, 341 (7th Cir. 2016).

It is settled in both New York and Illinois that the *in pari delicto* doctrine bars claims against co-conspirators for negligence. *See, e.g., Kirschner v. KPMG LLP*, 15 N.Y.3d 446, 464 (2010) ("The justice of the in pari delicto rule is most obvious where a willful wrongdoer is suing someone who is alleged to be merely negligent."); *Peterson v. McGladrey & Pullen, LLP*, No. 10 C 274, 2010 WL 4435543, at *4 (N.D. Ill. Nov. 3, 2010) ("[T]he *in pari delicto* principles that preclude plaintiff from seeking redress for [the trustee's] alleged negligence . . . apply equally to plaintiff's claims against [the defendant auditor.]"), *vacated on other grounds*, 676 F.3d 594 (7th Cir. 2012). Thus, the *in pari delicto* doctrine

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[10] In the district court, the parties disputed whether New York (where Citigroup and Merrill Lynch are headquartered) or Illinois (where Tribune was headquartered) law governed the Trustee's professional malpractice claim. This argument has been largely abandoned, likely because, as the district court explained, the states' laws are nearly the same.

precludes a corporation engaged in wrongdoing from suing its co-conspirators on the grounds of negligence.

2. Application

As an initial matter, accepting the Trustee's factual assertions to be true, he plausibly alleges that the Financial Advisors aided and abetted Tribune's directors and officers in breaching their fiduciary duties when they hid Tribune's true financial state to complete the LBO. In particular, the Trustee's complaint alleges that Citigroup and Merrill Lynch reviewed VRC's solvency analysis and failed to alert anyone that the February Projections, which formed the bedrock of VRC's first solvency opinion, were no longer accurate. Instead, they allowed VRC's analysis to be delivered to the financing banks at Step One of the LBO. Likewise, the Trustee contends that Citigroup's analysis showed that Tribune was insolvent by more than $1.4 billion before the close of Step Two, and Merrill Lynch's analysis showed that Tribune was insolvent by more than $1.5 billion. Still, neither tried to stop the LBO.

Indeed, for purposes of these appeals, Citigroup and Merrill Lynch do not challenge the allegations of wrongdoing or negligence. Instead, they contend that any aiding and abetting breach of fiduciary duty and malpractice claims must be dismissed based on the *in pari delicto* doctrine. And for his part, the Trustee does not argue on appeal that the *in pari delicto* doctrine is inapplicable; instead, he argues that two exceptions to that doctrine should apply to allow the claims to go forward -- the adverse interest exception, which it argued below to the district court, and the fiduciary/insider exception, which it argues for the first time on appeal. This Court has discretion to consider arguments waived below where necessary to avoid a manifest injustice. *In re Nortel Networks Corp. Sec. Litig.*, 539 F.3d 129, 133 (2d Cir. 2008). In circumstances where those arguments were available to the party below and no reason is proffered for their failure to raise them, such an exercise of discretion is not favored. *Id.*

a. *Adverse Interest Exception*

Here, the adverse interest exception does not apply because the LBO conferred at least some "benefit" on Tribune. *AIG II*, 976 A.2d at 891. Tribune received over $300 million in additional capital from Zell's investment, and there was also the potential for $1 billion in tax savings. Even putting aside the tax savings -- which Moody's called a "key assumption" for the LBO, 449 J. App'x at 112, but which were ultimately never realized **--** the transaction still infused hundreds of millions of dollars of capital into the business at a time when Tribune was struggling, provided value to many shareholders by helping cash them out, and gave Tribune a chance to continue as a going concern by allowing it to pay off at least some existing debt. Indeed, Tribune itself explained in a proxy statement that the LBO was in its best interest.

The Trustee also makes no specific allegations that support an inference that Tribune received *no* benefit from the LBO; instead, it contends that the net effect of the LBO was negative. But the net effect is not relevant when considering whether the adverse interest exception will apply. *Stewart*, 112 A.3d at 303. Therefore, despite any "long-term damage," *id.*, the adverse interest exception to the *in pari doctrine* does not apply in this case.[11]

b. *Fiduciary/Insider Exception*

The Delaware Chancery Court has explained that for the fiduciary/insider exception to apply, the party must "occupy a position of trust

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[11] Notwithstanding the Trustee's argument to the contrary, the district court did not resolve any issues of fact by holding that the adverse interest exception did not apply here. Instead, it simply observed that the infusion of $300 million in capital stated in the Complaint conferred some benefit on Tribune, and therefore, the defendants had not acted "*solely* to advance [their] own personal financial interest." *AIG*, 976 A.2d at 891 (emphasis added).

and materially participate in the traditional insiders' discharge of their fiduciary duties," thereby playing a "'gatekeeper' role vis-à-vis the [corporation]." *Stewart*, 112 A.3d at 319. Here, the Trustee has failed to sufficiently allege that any of the Financial Advisors played such a role.

While a corporation's auditors "assume[] a public responsibility transcending any employment relationship," *United States v. Arthur Young & Co.*, 465 U.S. 805, 817–18 (1984) (emphasis omitted), and act as the gatekeepers of standards designed to avoid damage to corporations, the Delaware Supreme Court has emphasized that "the role of a financial advisor is primarily contractual in nature" and that a financial advisor's "engagement letter typically defines the parameters of the financial advisor's relationship and responsibilities with its client," *RBC Cap. Mkts.*, 129 A.3d at 865 n.191. Here, the engagement letters between Tribune and Citigroup and between Tribune and Merrill Lynch expressly provide that they did not create fiduciary relationships and that Citigroup and Merrill Lynch were not acting as Tribune's agents. The letters instead made clear that Tribune would "make an independent analysis and decision regarding any Transaction based on [their] advice." 449 J. App'x at 366. Citigroup and Merrill Lynch were financial advisors, not "gatekeepers," *AIG II*, 976 A.2d at 890 n.49, and, further, neither Citigroup nor Merrill Lynch "materially participate[d]" in the discharge of fiduciary duties, *Stewart*, 112 A.3d at 320.

Moreover, the Delaware Supreme Court has cautioned against "inappropriately . . . suggest[ing] that any failure by a financial advisor to prevent directors from breaching their duty of care gives rise to an aiding and abetting claim against the advisor." *RBC Cap. Mkts.*, 129 A.3d at 865 n.191. Instead, such a claim may arise where "the [financial advisor] knows that the board is breaching its duty of care and participates in the breach by misleading the board or creating [an] informational vacuum." *Id*. at 862.

Here, although the Trustee lodges numerous allegations of misconduct on the Financial Advisors' part, there is little to suggest that their conduct created an "'informational gap[]' . . . l[eading] to the Board's breaches of fiduciary duties," as occurred in *Stewart*, 112 A.3d at 322, much less the "fraud on the Board" and "intentional[] dup[ing]" of directors that warranted liability of the financial advisor in *RBC Cap. Mkts.*, 129 A.3d at 865. Rather, the Trustee alleges that Tribune's officers and advisors conspired with their financial advisors (among others) to carry out the LBO.

Accordingly, the district court did not err in dismissing the Trustee's aiding and abetting breach of fiduciary duty and professional malpractice claims against the Financial Advisors.

B. ***Intentional Fraudulent Conveyance Claims***

As discussed above, the Bankruptcy Code allows a bankruptcy trustee to recover transfers made with "actual intent to hinder, delay, or defraud" creditors. 11 U.S.C. § 548(a)(1)(A). The complaint does not sufficiently allege that the transfers to Citigroup, Merrill Lynch, and Morgan Stanley as financial advisors were made with an "actual intent to hinder, delay, or defraud" creditors. *Id.* It does, however, sufficiently plead such an actual intent as to VRC.

As to Morgan Stanley, the complaint alleges that Tribune paid the firm $10 million for a fairness opinion, but the complaint then barely mentions the fairness opinion again, much less suggest that payment for the opinion was motivated by fraudulent intent. Without additional allegations, the Trustee cannot satisfy Rule 9(b)'s heightened pleading standard as to Morgan Stanley.

As to Citigroup and Merrill Lynch, the Trustee's allegations -- that these firms "were incentivized to promote the LBO over other proposals being considered by [Tribune]," 3049 J. App'x at 59, and that they "purported to rely on the unrealistic February 2007 Projections even as each month's below-projection performance showed conclusively that they could not be achieved," 3049 J. App'x at 118 -- are insufficient to support an inference of intent to defraud as to the payment of their financial advisory fees. *Kaiser*, 722 F.2d at 1582.

Specifically, the Trustee maintains that "multiple badges of fraud" support the requisite strong inference of fraudulent intent against Citigroup and Merrill Lynch, including that (1) the advisory fees were paid to these firms in December 2007, following the close of Step Two when Tribune was insolvent; (2) Tribune received less than reasonably equivalent value for the fees paid; (3) the fees were not paid in the ordinary course of Tribune's business; and (4) Tribune's management engaged in deceptive conduct by concealing the February and October Projections from certain others in management, and induced Citigroup and Merrill Lynch to use those projections to bring the LBO to a close. 449 Appellant's Br. at 53.

Regarding this first alleged badge of fraud, payments to Citigroup and Merrill Lynch when Tribune was insolvent weigh in favor of finding actual fraudulent intent. As to the second badge of fraud, whether Tribune received reasonably equivalent value for these payments is a disputed factual question, which also weighs in the Trustee's favor at this stage.

As to third badge of fraud, nothing in the pleadings supports the notion that fees paid to Citigroup and Merrill Lynch pursuant to their respective engagement letters were outside the ordinary course of Tribune's business. Rather, the pleadings on these payments relate to the tortious performance of financial advisory services and the alleged fraudulent nature of the LBO transaction as a whole. They do not admit an inference of fraudulent intent as to Tribune's specific payment of the advisory fees, *see Sharp*, 403 F.3d at 56, which occurred pursuant to engagement letters entered into with Citigroup and Merrill Lynch in October 2005, long before the LBO was proposed.

As to the fourth badge of fraud, the Trustee's allegations of deceptive conduct by Tribune's management are too attenuated from the advisory fee payments to Citigroup or Merrill Lynch to indicate Tribune's intent as to those payments. At most, the Trustee's allegations indicate that Citigroup and Merrill Lynch did not report Tribune's management's concealment of facts. But other checks on such behavior existed as Morgan Stanley and the Special Committee independently reviewed the relevant figures.

In sum, the Trustee's highlighted badges of fraud fail to raise a strong inference of fraudulent intent. In the absence of other common badges of fraud -- reserving rights in the property, hiding funds, and paying an unconscionable price, *Kaiser*, 722 F.2d at 1582 -- the Trustee has not satisfied the heightened pleading standard for demonstrating an actual fraudulent conveyance as to Citigroup and Merrill Lynch.

The Trustee contends that these same "multiple badges of fraud" also support the requisite strong inference of fraudulent intent as to VRC. The first alleged badge of fraud weighs against finding actual fraudulent intent because VRC received the majority of its payment before Step Two closed and, therefore, prior to Tribune's insolvency.

As to the second alleged badge of fraud, whether Tribune received reasonably equivalent value for these payments is again a disputed factual question, weighing in the Trustee's favor at this stage.

The third alleged badge of fraud favors a finding of actual fraudulent intent for the payments made to VRC. Specifically, the Trustee alleges that: Tribune hastily hired VRC after Duff & Phelps, the company initially hired to perform a solvency analysis, informed Tribune that it could not provide a favorable solvency opinion, and after another "prominent" valuation firm rebuffed Tribune, 3049 J. App'x at 211; VRC charged Tribune the highest fee it had ever charged for a solvency opinion; and VRC agreed, among other things, to define "fair value," *id.* at 212, inconsistently with the industry standard upon which VRC had relied for its previous solvency opinions. These allegations are sufficient to admit an inference that the VRC payments were outside the ordinary course of Tribune's business. *See In re Lehman Bros. Holdings Inc.*, 469 B.R. 415, 447–49 (Bankr. S.D.N.Y. 2012) (concluding that actual intent was sufficiently pled where allegations included, *inter alia*, that "each transaction . . . was unprecedented in the prior course of business between the parties, and the industry generally").

As to the fourth badge of fraud, the Trustee persuasively argues that Tribune's management's manipulation of the definition of "fair value" in its engagement letter with VRC was deceptive conduct that was (1) necessary for the LBO to proceed and (2) directly tied to Tribune's payments to VRC, in that VRC was retained precisely because it was willing to employ such a definition in formulating a solvency opinion. Further, the questionable nature of the "fair value" definition is highlighted by VRC's charge of an unprecedented fee to take the assignment.

In sum, as to Morgan Stanley, Citigroup, and Merrill Lynch, we agree with the district court that the pleaded badges of fraud are insufficient to create a strong inference of actual fraudulent intent. As to VRC, however, we conclude that the Trustee has sufficiently pleaded actual fraudulent intent.

C. *Constructive Fraudulent Conveyance Claims*

A trustee may recover "constructive" fraudulent transfers where "the debtor . . . received less than a reasonably equivalent value in exchange for such transfer or obligation" and: (1) "was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation"; (2) "was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital"; (3) "intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured"; or (4) "made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business." *See* 11 U.S.C. § 548(a)(1)(B).

The Bankruptcy Code does not define "reasonably equivalent value," only defining "value" as the "satisfaction . . . of a present or antecedent debt of the debtor." *Id.* § 548(d)(2)(A). This court, however, has stated that "reasonably equivalent value is determined by the value of the consideration exchanged between the parties *at the time of the conveyance or incurrence of debt* which is challenged." *In re NextWave Pers. Commc'ns, Inc.*, 200 F.3d 43, 56 (2d Cir. 1999) (internal quotation marks omitted). Hence, in determining whether the debtor received "reasonably equivalent value," the court "need not strive for mathematical precision" but "must keep the equitable purposes of the statute firmly in mind, recognizing that any significant disparity between the value received and the obligation assumed . . . will have significantly harmed the innocent creditors." *Rubin v. Mfrs. Hanover Tr. Co.*, 661 F.2d 979, 994 (2d Cir. 1981) (discussing § 67(d) of the Bankruptcy Act of 1898, predecessor to § 548 of the Bankruptcy Code); *see also United States v. McCombs*, 30 F.3d. 310, 326 (2d Cir. 1994) ("[T]he concept [of fair consideration] can be an elusive one that defies any one precise formula." (discussing N.Y. Debt. & Cred. Law § 272)).

To determine whether reasonably equivalent value was provided, "the Court must ultimately examine the totality of the circumstances, including the arms-length nature of the transaction; and . . . the good faith of the transferee." *In re Bernard L. Madoff Inv. Sec. LLC*, 454 B.R. 317, 334 (Bankr. S.D.N.Y. 2011) (internal quotation marks omitted).

Where the reasonably equivalent value analysis requires "more than a simple math calculation," such a computation usually should not be made at the motion to dismiss stage. *Id.*; *see also In re Agape World, Inc.*, 467 B.R. 556, 571 (Bankr. E.D.N.Y. 2012). Still, while the determination of whether reasonably equivalent value was exchanged is "largely a question of fact," *Am. Tissue Inc. v. Donaldson, Lufkin & Jenrette Secs. Corp.*, 351 F. Supp. 2d 79, 105 (S.D.N.Y. 2004) (internal quotation marks omitted); *accord In re Jesup & Lamont, Inc.*, 507 B.R. 452, 470 (Bankr. S.D.N.Y. 2014), courts have dismissed constructive fraudulent transfer claims where the complaint does not plausibly allege that the debtor received less than reasonably equivalent value, *see, e.g.*, *In re Trinsum Grp., Inc.*, 460 B.R. 379, 388–89 (Bankr. S.D.N.Y. 2011) (dismissing constructive fraudulent transfer claims due to the trustee's failure to sufficiently plead the less than reasonably equivalent value requirement); *In re Bernard L. Madoff Inv. Sec. LLC*, 458 B.R. 87, 113–15 (Bankr. S.D.N.Y. 2011) (dismissing certain of Trustee's claims that failed to meet the particularity requirement and relied on transfers outside the applicable time period).

Here, the various Financial Advisors are differently situated. Upon *de novo* review, we conclude that the constructive fraudulent conveyance claims against Citigroup and Merrill Lynch cannot be dismissed on the pleadings, but those against Morgan Stanley and VRC were properly dismissed.

As to Citigroup and Merrill Lynch, the Trustee alleges that the $12.5 million success fee paid to each firm upon consummation of the LBO was a constructive fraudulent conveyance. We first consider "the time of the conveyance or incurrence of debt" to determine whether there was reasonably equivalent value. *NextWave*, 200 F.3d at 56 (emphasis and citation omitted). The district court found that the debt was incurred when Citigroup's and Merrill Lynch's engagement letters were signed, years before the LBO's completion, thus rendering the success fees that the Trustee seeks to claw back unavoidable antecedent debt. We conclude otherwise.

The pleadings record indicates that Citigroup's and Merrill Lynch's success fees were not debts incurred or owed until December 2007 when the LBO closed at Step Two, at which point a triggering "Strategic Transaction" took place. Indeed, under their engagement letters, Citigroup and Merrill Lynch were entitled to payment of their success fees only "upon consummation of a Transaction involving" Tribune. 449 J. App'x at 368. Accordingly, the financial firms were only paid their success fees after the completion of Step Two and the closure of the LBO. Further, the engagement letters required Tribune to reimburse Citigroup and Merrill Lynch for all reasonable expenses incurred in providing financial advisory services prior to the consummation of the LBO, "[r]egardless of whether any [t]ransaction [was] proposed or consummated." 449 J. App'x at 368; *see also id.* at 376. This suggests that Tribune's obligations to pay the two $12.5 million success fees were separate, additional debts that were only payable in the event of a successful transaction. Accordingly, because the success fees were only incurred upon consummation of the LBO, they were not antecedent debt constituting categorically reasonably equivalent value.

Because the Trustee has adequately pleaded Tribune's insolvency upon the completion of Step Two, it is plausible that Tribune: (1) was "insolvent on the date" that the success fees were paid; (2) was engaged in the transaction of paying the success fees while it retained "unreasonably small capital"; and/or (3) "incurred" the success fees, which may have been "beyond [its] ability to pay." Therefore, the issue of whether Citigroup's and Merrill Lynch's success fees constitute a constructive fraudulent transfer hinges on whether the services that Tribune received in exchange were of "reasonably equivalent value." 11 U.S.C. § 548(a)(1)(B).

Turning then to the question of "reasonably equivalent value," we note that according to Citigroup and Merrill Lynch's engagement letters, Tribune owed success fees only if the advisors performed satisfactorily. Specifically, Citigroup's engagement letter states that it will "perform such financial advisory and investment banking services for [Tribune] in connection with the proposed Transaction as are customary and appropriate in transactions of this type." Merrill Lynch's engagement similarly states that it "will perform such financial advisory and investment banking services for [Tribune] as are customary and appropriate in transactions of this type." The Trustee alleges that Citigroup and Merrill Lynch fell short of "customary and appropriate" industry standards, were grossly negligent in carrying out their responsibilities, and rendered their services in bad faith. Thus, according to the Trustee, because these firms provided "no value" to Tribune, consummation of the LBO would not trigger the contractual obligation to pay fees and the success fees should be clawed back.

On a motion to dismiss, we must accept factual allegations as true as long as they are not "threadbare recitals of the elements of a cause of action, supported by mere conclusory statements." *Nielsen v. Rabin*, 746 F.3d 58, 62 (2d Cir. 2014) (alteration and internal quotation marks omitted).

The complaint alleges plausible facts that Citigroup and Merrill Lynch knew or should have known the February Projections would not be met and that each firm thought Tribune was insolvent by over $1 billion, and that they yet failed to act.

To determine whether the Financial Advisors' guidance met the standard of reasonably equivalent value, courts evaluate the totality of the circumstances, considering, *inter alia*, the number of hours worked, industry standards, fees paid compared to the overall size of the transaction, when the engagement letters were signed, and opportunity costs. Here, the determination of whether the Citigroup and Merrill Lynch provided reasonably equivalent value likely requires more than "a simple math calculation." *Madoff*, 454 B.R. at 334. Unlike in *In re Old Carco LLC*, where the trustee's allegations simply "appl[ied] implausible values" or "omit[ted] other key assets," 509 F. App'x 77, 79 (2d Cir. 2013) (summary order), the Trustee in this case alleges, amongst other failings, that Citigroup and Merrill Lynch failed to advise Tribune about the flaws in VRC's Step One solvency analysis, which stemmed from the February Projections that the firms knew would not be met. The Trustees also alleges that both Citigroup's and Merrill Lynch's analyses showed Tribune was insolvent by more than $1 billion before the close of Step Two. How much, if at all, this ought to detract from the fees they were paid should not have been decided on a motion to dismiss. *See In re Actrade Fin. Techs. Ltd.*, 337 B.R. 791, 804 (Bankr. S.D.N.Y. 2005) ("[T]he question of 'reasonably equivalent value' and 'fair equivalent' is fact intensive, and usually cannot be determined on the pleadings."); *see also In re Andrew Velez Const., Inc.*, 373 B.R. 262, 271 (Bankr. S.D.N.Y. 2007) (declining to dismiss constructive fraudulent transfer claim given the complexities of the factual background giving rise to the issue of "reasonably equivalent value").

While it is a close call, because we are required to accept the allegations in the Trustee's complaint as true, we conclude the factual question of whether Citigroup and Merrill Lynch provided reasonably equivalent value for their success fees cannot be decided without first assessing whether the banks satisfactorily performed their duties. Thus, dismissal of the constructive fraudulent conveyance claims against these parties was premature.

In contrast, we find no error in the dismissal of these claims against Morgan Stanley and VRC. While these firms adopt the arguments set forth by Citigroup and Merrill Lynch, their actions differ in several important respects. First, Morgan Stanley was hired as advisor for and was responsive to a different part of Tribune -- the Special Committee. Second, Morgan Stanley and VRC did not have the same incentives as Citigroup and Merrill Lynch. Because both Morgan Stanley and VRC earned their respective fees upon delivery of their contracted-for opinions, they had no financial stake in the LBO's consummation. Finally, and most important, the Morgan Stanley and VRC payments were in large part due *before* Step One closed. Because there is hardly an allegation that Tribune was insolvent before the first step, the constructive fraudulent transfer claims against Morgan Stanley and VRC must fail.

VI. *Leave to Amend*

The Trustee sought leave to amend his complaint as to the shareholders in two respects: first, to provide additional allegations in support of his intentional fraudulent conveyance claims and, second, to add a constructive fraudulent conveyance claim. The district court denied both requests.

"[L]eave [to amend] shall be freely given when justice so requires." *Ronzani v. Sanofi S.A.*, 899 F.2d 195, 198 (2d Cir. 1990) (citing Fed. R. Civ. P. 15(a)(2)). A court may deny leave to amend, however, for a "valid ground," *id.*, such as futility or undue prejudice, *see Foman v. Davis*, 371 U.S. 178, 182 (1962). "Futility is a determination, as a matter of law, that proposed amendments would fail to cure prior deficiencies or to state a claim under Rule 12(b)(6) of the Federal Rules of Civil Procedure." *Empire Merchs., LLC v. Reliable Churchill LLLP*, 902 F.3d 132, 139 (2d Cir. 2018). To determine whether granting leave to amend would be futile, we consider the proposed amendments and the original complaint. *See Pyskaty v. Wide World of Cars, LLC*, 856 F.3d 216, 225–26 (2d Cir. 2017).

A. *Intentional Fraudulent Conveyance Claims*

In denying the Trustee leave to amend his intentional fraudulent conveyance claims, the district court noted that the Trustee gave "no clue as to how the complaint's defects would be cured." 3049 S. App'x at 26 (alteration omitted). On appeal, the Trustee argues that if given the opportunity to amend, he would have been able to satisfy the imputation standard applied by the district court.

We are not persuaded. The Trustee had ample opportunity to plead a viable claim in the district court -- indeed, the operative pleading was the *Fifth* Amended Complaint -- but he failed to propose any amendments that would cure the pleading defects. Nor has he identified on appeal any additional factual allegations that would give rise to a strong inference of fraudulent intent on the part of the Special Committee. Accordingly, we find no abuse of discretion in the district court's denial of leave to amend the Trustee's intentional fraudulent transfer claims.

B. *Constructive Fraudulent Conveyance Claims*

The Trustee did not initially assert a constructive fraudulent transfer claim against the shareholders but sought leave to file a Sixth Amended Complaint to add such a claim. On April 23, 2019, the district court (Cote, *J.*) denied the request, on two independent grounds: (1) the shareholders would suffer substantial prejudice; and (2) the proposed amendments to the constructive fraudulent transfer claim would be futile.

Under the Bankruptcy Code, certain transactions fall within a safe harbor and the payments that are part of those transactions cannot be clawed back via a federal constructive fraudulent transfer claim. *See* 11 U.S.C. §§ 544, 546(e). These include a payment made "in connection with a securities contract" if that payment was made by "a financial institution." *Id.* at § 546(e). As we held in *Tribune II*, however, Tribune's payments to its shareholders fell within this safe harbor. *See* 946 F.3d at 77–81, 90–97 (holding that Tribune was a "financial institution" within meaning of safe harbor provision and that payments to shareholders were payments "in connection with a securities contract"). On appeal, the Trustee argues that the district court and the *Tribune II* panel improperly concluded that Tribune was a financial institution, first by incorrectly taking judicial notice of certain documents and second by misinterpreting those documents. We are not persuaded.

As an initial matter, we are bound by the *Tribune II* panel's decision that Computershare Trust Company ("CTC"), a financial institution for purposes of § 546(e), was Tribune's agent when it served as a depository to help effectuate the LBO, which was a securities contract. *Tribune II*, 946 F.3d at 78-81; *see also* *4 Pillar Dynasty LLC v. New York & Co., Inc.*, 933 F.3d 202, 211 n.8 (2d Cir. 2019)

("We are bound by the decision of prior panels until such time as they are overruled either by an en banc panel of our Court or by the Supreme Court." (internal quotation marks omitted)).

The Trustee takes issue with how the district court took judicial notice of certain documents to conclude that CTC was Tribune's agent. That argument is without merit, as "[w]e have recognized . . . that in some cases, a document not expressly incorporated by reference in the complaint is nevertheless 'integral' to the complaint and, accordingly, a fair object of consideration on a motion to dismiss." *Goel v. Bunge, Ltd.*, 820 F.3d 554, 559 (2d Cir. 2016). "A document is integral to the complaint where the complaint relies heavily upon its terms and effect." *Id*. (internal quotation marks omitted). Here, the documents the district court relied on were the contracts that set forth the relationship between Tribune and CTC, and they were therefore integral to the complaint.

Similarly, the Trustee's argument that CTC was not Tribune's agent because it was given no discretion and was not a fiduciary lacks merit. Here, Tribune entered into an agreement with CTC whereby CTC was hired to be a steward of Tribune's money and its shareholders' stock. It was clearly acting on behalf of Tribune, which is enough to satisfy § 546(e). Accordingly, even on *de novo* review, the district court did not err when it denied the Trustee leave to amend its complaint as futile.

Separately, the district court did not abuse its discretion when it alternatively refused to grant leave to amend because doing so would be unduly prejudicial. There are thousands of shareholders who have been impacted by this ongoing litigation, all of whom relinquished control of their stock more than twelve years ago. As both this Court and the district court pointed out, allowing another amended complaint would prevent "certainty, speed, finality, and stability" in the market. 3049 S. App'x at 27 (citing *Tribune II*); *see also Trs. of Upstate N.Y. Eng'rs Pension Fund v. Ivy Asset Mgmt.*, 843 F.3d 561, 568 (2d Cir. 2016) (discussing the importance of finality).

Accordingly, we conclude that the district court did not abuse its discretion in denying the Trustee leave to amend his complaint to add a constructive fraudulent claim under federal law.

CONCLUSION

For the foregoing reasons, the judgment and orders of the district court are **AFFIRMED in part** and **VACATED in part** as follows:

1. the district court's dismissal of the intentional fraudulent conveyance claims against the shareholders based on the buy-back of their shares is **AFFIRMED**;

2. the district court's dismissal of the breach of fiduciary duty and aiding and abetting breach of fiduciary claims against the allegedly controlling shareholders is **AFFIRMED**;

3. (a) the district court's dismissal of the aiding and abetting breach of fiduciary duty and professional malpractice claims against the Financial Advisors is **AFFIRMED**;

(b) the district court's dismissal of the actual fraudulent conveyance claims is **AFFIRMED** as to Morgan Stanley, Citigroup, and Merrill Lynch and **VACATED** as to VRC; and

(c) the district court's dismissal of the constructive fraudulent conveyance claims is **AFFIRMED** as to Morgan Stanley and VRC and **VACATED** as to Citigroup and Merrill Lynch; and

4. the district court's denial of the Trustee's motion for leave to amend to amplify his intentional fraudulent conveyance claim against the

shareholders and to add a constructive fraudulent conveyance claim against the shareholders is **AFFIRMED**.

The case is hereby **REMANDED** for further proceedings in accordance with the above.

TAB 4

22 B.R. 166
United States Bankruptcy Court, E. D. New York.

In re VANIMAN INTERNATIONAL, INC., Debtor. Joseph T. PIRRONE and James A. Martin, Plaintiffs, v. Leonard TOBOROFF, as Trustee of the Estate of Vaniman International, Inc., Debtor, Defendant.

Bankruptcy No. 180-03984-21.
|
Adv. No. 180-0731-21.
|
July 13, 1982.

Synopsis
In bankruptcy proceeding, principals of debtor corporation were seeking recognition of validity of mortgage held on realty formerly belonging to the debtor corporation, claimed by trustee in bankruptcy to be voidable as a fraudulent conveyance and as a preference. Similarly, the trustee challenged transfer to principals of certain life insurance policies. In addition, trustee sought to recover $35,000 from the principals as disbursed by them in breach of their fiduciary duty to the debtor corporation when principals were in control of that corporation. The Bankruptcy Court, Cecelia H. Goetz, J., held that: (1) second mortgage held by principals of debtor corporation on realty formerly belonging to the corporation and transferred to the principals of life policies held by debtor were voidable as fraudulent conveyances; (2) even if second mortgage and transfer of life policies were not voidable as fraudulent conveyances, they were voidable as preferential payments; and (3) principals were not personally liable to estate of debtor corporation for monies paid to another corporation as a bribe.

Ordered accordingly.

Attorneys and Law Firms

***168** Pinks & Feldman, Melville, N. Y., for plaintiffs; Bernard S. Feldman, Melville, N. Y., of counsel.

Chester B. Salomon, New York City, for Trustee of the Estate of Vaniman International, Inc.

OPINION

CECELIA H. GOETZ, Bankruptcy Judge:

In this proceeding, the plaintiffs, Joseph T. Pirrone and James A. Martin, are seeking recognition of the validity of a mortgage held on realty formerly belonging to the debtor, Vaniman International, Inc. ("Vaniman"), claimed by Vaniman's trustee in bankruptcy to be voidable as a fraudulent conveyance and as a preference. On similar grounds the trustee challenges the transfer to them of certain life insurance policies. In addition, the trustee seeks to recover $35,000 from the plaintiffs as disbursed by them in breach of their fiduciary duty to the debtor corporation when the plaintiffs were in control of that corporation.

When Vaniman filed its voluntary petition under Chapter 11 of the Bankruptcy Code, 11 U.S.C. s 1101 et seq., on July 11, 1980, a mortgage foreclosure proceeding brought by the plaintiffs in the Supreme Court of the State of New York, County of Suffolk, was automatically stayed under s 362(a) of the Code, 11 U.S.C. s 362(a). This proceeding was initiated by plaintiffs on September 9, 1980 to lift that stay so that they might proceed with their foreclosure proceeding. Alternatively, plaintiffs sought an order directing Vaniman to surrender possession of the real property, or an order under s 361, 11 U.S.C. s 361, for adequate protection in the event Vaniman was permitted to continue using this property.

On September 24, 1980, Vaniman served an answer and counterclaims which were adopted and expanded by Leonard Toboroff, trustee of the estate of Vaniman, subsequent to the conversion of Vaniman's bankruptcy proceeding to Chapter 7. 11 U.S.C. s 701 et seq. In essence, the counterclaims assert that the creation of the mortgage and the transfer to the plaintiffs of certain life insurance policies constitute a fraudulent conveyance which the trustee can avoid under ss 544(a) and (b), and 548 of the Bankruptcy Code; that the transfers ***169** of the life insurance policies were preferences which the trustee can avoid under s 547 of the Bankruptcy Code; and that certain payments of monies by Vaniman in 1976 to an employee of Ford Motor Company-Export Division constituted a breach of the plaintiffs' fiduciary duty to Vaniman, for which they are liable to the trustee under s

541(a)(1) of the Bankruptcy Code and New York Business Corporation Law s 720(b).

On February 24, 1981, the property covered by the plaintiffs' mortgage was sold through the bankruptcy court with liens to attach to the proceeds, mooting plaintiffs' complaint insofar as it seeks relief from stay and converting it to a claim to a right to a portion of the proceeds of such sale now in the possession of the trustee.

At the close of the trial, the trustee moved to conform the pleadings to the proof, a motion which the Court has granted.

FINDINGS OF FACT

A. Description of Vaniman

1. Vaniman is a New York corporation, organized in 1953, which specialized in the manufacture, installation, and repair of truck bodies and related equipment (PXs-1-3; 53, 459). Its business was located at 30 Central Avenue, Farmingdale, New York (61).[1]

2. Joseph T. Pirrone joined Vaniman in 1956 after eleven years of employment in the Export Division of General Motors Corporation (289, 961, 993-94). At Vaniman, he was in charge of sales (288). The area of specialization of the plaintiff, James A. Martin ("James Martin" or "Martin"), was finance (198).

3. From 1970 to September 4, 1979, Joseph T. Pirrone and Martin held a majority of the outstanding stock of Vaniman (57-58) and on September 4, 1979 owned all the corporation's stock (60, 346). From January 1, 1977 to September 4, 1979, Joseph T. Pirrone was President of Vaniman and Martin was its Executive Vice President (58-59). From January, 1977 to September 4, 1979, the directors of Vaniman were Pirrone, Martin, and three other men, two of whom ceased being directors sometime prior to September 4, 1979 (59-60). Although Pirrone ceased to be President of Vaniman on September 4, 1979, he continued to be an officer of that company until sometime in 1980 (361).

4. Pirrone has known Martin since 1955, and they have been partners in Vaniman since the late 1950s (196). Between 1975 and September 4, 1979, Pirrone discussed with Martin major policy issues, advised him of large orders, and Martin, in some instances, assisted Pirrone in arriving at the prices that Vaniman quoted for jobs (197-98). Martin and Pirrone shared responsibility for the operations of Vaniman's business: Martin had an "equal say-so" with Pirrone (198). When a large piece of equipment would be required, Pirrone consulted with Martin before undertaking the commitment (198-99). On matters of importance, there was an understanding between them that there would be agreement before the corporation would undertake a particular course of action (199).

5. Although Martin, unlike Pirrone, was not present at the premises of Vaniman on a daily basis, going there only 30 or 40 times per year prior to the sale of his stock on September 4, 1979 (1230-31), Martin, up to that date, was equally responsible with Pirrone for the operation of the business of Vaniman.

B. 1975-1978

6. In 1975-76, Pirrone, as an officer of Vaniman, negotiated with the Ford Motor Company-Export Division for a contract to install truck bodies on a shipment of 680 vehicles intended for the Nigerian Army (214, 300-302). After Vaniman submitted a bid of $2,390 per vehicle (302), which would have yielded a profit of $378-$380 per vehicle (304), or about $260,000 in all (214, 304), the general manager of the Ford Division, Michael Colletti, requested Pirrone to meet ***170** him in Fort Lauderdale, Florida (307-310). At that meeting, Colletti told Pirrone that Vaniman would not receive the order unless it paid Colletti a "commission" of $100 per truck (214-15, 313-15).

7. Present also at the meeting with Colletti and Pirrone was the President of Aacon Contracting Co. which Colletti suggested carry out the actual work required to complete the contract (312).

8. Pirrone objected to payment of the commission, but Colletti made it plain that otherwise Vaniman would lose the contract (314-15). On Pirrone's return from Florida, he advised Martin of Colletti's demand, and Martin, although he was not pleased, authorized the transaction (225-33).

9. Vaniman was awarded the Ford contract in November, 1975, eight weeks after the Florida meeting (316). It was the largest order in Vaniman's two-decade history, amounting to $1,625,000 (214, 318, 1204).

10. During the months of September, October, and December, 1976, Vaniman, at the direction of Colletti, paid $35,000 in four or five checks to CP&T Sales Co., a corporation designated by Colletti to receive the agreed-upon commission

(216-17, 236-39, 320; Ex. L). Pirrone made the payments until he was told by Colletti to stop because a problem had developed (319-23).

11. Vaniman itself did no work on the contract. The work was performed by Aacon Contracting Co. Vaniman's role was evidently limited to checking daily on the progress of the work so that it could bill for it (316), as the following colloquy established: "THE COURT: * * * You did absolutely nothing more than collect the money? THE WITNESS (James Martin): That was the delightful part of it." (1234).

12. As a result of the Ford contract, Vaniman realized a profit of $220,000 in 1976 (325, 382-83, 385). Its total net income for that year was $50,580.55 (383) on gross sales of $2,877,605.39, of which the Ford order represented more than 50 percent (381-82).

13. There is no evidence that Martin or Pirrone received any benefit from the payments made by Vaniman to CP&T Sales Co., nor that either derived any personal benefit directly or indirectly from the Ford contract, except in their capacity as stockholders of the Vaniman corporation. But for the money collected from Ford in connection with Colletti's misconduct, Vaniman would have operated at a loss, indicating that its regular operations were no longer profitable.

14. 1976, the year of the Ford order, was the last year on which Vaniman showed a profit. Neither that year, nor in any subsequent year, was any money spent by Vaniman for new equipment (DXs-A, C, D, L).

C. 1977-78

15. The American automobile industry began declining some time in the 1970s along with the economy, and Vaniman's sales reflected the difficult time the industry was experiencing (63-64).

16. During 1977, Vaniman lost $92,000 on sales of nearly. $1.4-million (Schedule 3 to DX-A). At the close of that year, its current liabilities exceeded its current assets by over $100,000 (DX-A, at schedules 1, 2).

17. In 1978, Pirrone requested a real estate expert to place a value on Vaniman's realty and received a letter dated March 1, 1978 from William E. Greiner of the firm of Greiner Maltz Co., Inc., a real estate broker, which appraised the property in which Vaniman carried on its business-the building and the plot on which it was located-as having a current market value "for a truck repair operation" of $380,000 (DX-A). John T. Brady included this letter in Vaniman's financial statement for 1977 which showed $380,000 as the market value of the Vaniman realty (DX-A, at Schedule 1).

18. On May 16, 1978, when Vaniman applied to the Farmingdale branch of the Hempstead Bank for credit, that bank, after examining Vaniman's financial statements, refused to lend it money without collateral. In order to get the loan, Pirrone provided the bank with collateral from his own personal assets (66, 1037, 1043-46).

***171** 19. On May 9, 1978, Pirrone appeared before a Grand Jury which was investigating Colletti and flatly denied that Colletti ever directly or indirectly solicited or requested money from him or his companies in connection with any of their work for Ford (DX-S; see also 324-25). Later he admitted his perjury (DX-R, at 15-16), and on April 2, 1979, executed an agreement with the United States Attorney committing him to cooperate with the ongoing investigation of Colletti (DX-R, at 3-4).

20. Pirrone's efforts in 1978 to sell Vaniman or its stock were all unsuccessful (421). But Pirrone did receive an offer in November, 1978 for Vaniman's real estate. That month, Rick Kreindler of Rick Kreindler Associates, Inc., a real estate firm, wrote Pirrone that he was authorized by Bucknell Press, Vaniman's neighbor, to offer $375,000 for that property, an offer that Pirrone turned down (PX-4; 446-47). Earlier, Pirrone had told Kreindler that for the property alone, Vaniman wanted "$425,000 on the net side" (447).[2]

21. During 1978, Vaniman's sales continued their decline. Its gross sales that year dropped to $1,143,975.19, and its operating losses doubled to $195,812.76 (DX-C, at schedule 3).

22. By the end of 1978, Vaniman was even deeper in debt than at the close of the previous year. As of December 31, 1978, its current assets were $201,479.71, against current liabilities of $522,651.10 (DX-C, at schedules 1, 2).

23. The difference between a company's current assets and current liabilities constitutes its working capital. A deficit in working capital signifies that a company is unable to pay its bills as they become due (744-45). In Vaniman's case, its deficit in working capital had grown in the space of one year from $106,813.93 in 1977 (DX-A, at schedules 1, 2) to $321,171.39 in 1978 (DX-C, at schedules 1, 2).

24. The balance sheets in Vaniman's financial statements for both 1977 and 1978 show figures labeled “Book Value” and figures labeled “Market Value” (DX-A, at schedules 1, 2; DX-C, at schedules 1, 2). The principal differences between “Book Value” and “Market Value” are due to the higher market values attributed to Vaniman's real estate and fixed assets as compared with their book values. In each case, the market value of the real estate is stated to be $380,000; in 1977, the market value of Vaniman's fixed assets was put at $66,000, in 1978 at $70,000. Based on Book Value, Vaniman's liabilities at the end of 1978 exceeded its assets by $179,485.26; based on the claimed Market Value, assets exceeded liabilities by $52,744.34 (DX-C, at schedules 1, 2).

D. 1979

25. In 1979, Vaniman's sales continued their decline. During the first eight months of that year, its total sales fell to $362,416.68 which projected on a 12-month basis would be around $550,000. This represented about one-third of its sales in 1977, and less than one-half its sales in 1978, both years in which it had lost money. Its financial statement for the period shows a net loss of $10,813.94 (DX-D, at schedule 3).[3]

26. With Vaniman's sales at their lowest level in its history, and with a two-year-old deficit in working capital, Vaniman was unable to meet its bills as they fell due. By mid-1979, some creditors had not been paid for over a year (64-65); Peabody Galion was owed in excess of $108,000 (65, 554-55, 1117; cf. DX-M); other creditors, including Dover Corporation, were suing for payment (498, 510-11 (Dover); 500 (Ford)).

27. To meet its most pressing obligations, Vaniman had to borrow funds. It increased its borrowing from the Hempstead ***172** Bank, so that as of April 3, 1979, it owed that Bank $46,500, secured by Pirrone's collateral (1046-47). It also borrowed from its officers and employees. Martin lent Vaniman $10,000 in January or February, 1979 to pay its real estate taxes (354); Pirrone lent it $23,857.63 to meet its payroll and operating expenses (353-54); Robert Kral, its service manager, lent it $10,000 in May or June, 1979 to meet its payroll (351-52).

28. In March or April, 1979, one Joseph L. Cote, advised of the possible availability of the Vaniman building by Greiner Maltz Real Estate, began negotiating with Pirrone and Martin to buy the stock of Vaniman (157-169, 259-70, 932-35, 939-40). At the time Cote was associated with Great Escape Motor Homes, Ltd. (“Great Escape”), of which Jack Martin was then general manager (572, 598-99). Jack Martin served as Cote's intermediary and Pirrone gave him Vaniman's financial statements for 1977 and 1978 to transmit to Cote (166-69, 462-67, 478-79, 613-14, 934). Sometime in late June, or early July, the deal with Cote collapsed (169, 270, 476-77), and around the same time, Jack Martin ceased to be an employee of Great Escape, which itself went out of business in early July (472-73, 623). It was then that Pirrone and Jack Martin began discussing having Martin buy the Vaniman stock (169-70, 271-72, 477) and Martin was given Vaniman's financial statements for his own use (123, 479-80, 642).

29. In the summer of 1979, Jack Martin was twenty-eight years old (457). His education had stopped with high school (458). Neither he, nor his wife, had any money (458-59). Virtually all his employment had been as a salesman, except for a brief two-year period when he had operated as a franchisee for Snap-On Tools, a business venture which had ended in his personal bankruptcy, owing $40,000 (576-80, 590-93). He had no experience or knowledge respecting the type of business in which Vaniman was engaged and had no financial background (459).

30. Of all these facts he advised Pirrone. He had ample opportunity to do so since, starting June 1, 1979, when Great Escape leased the back half of the Vaniman premises, he was present at Vaniman on a daily basis (469-70). While there, he engaged in frequent conversations with Pirrone telling Pirrone everything he had done from high school on, including the details of his personal bankruptcy (471-72, 493, 643-44). When Pirrone requested a personal financial statement, he told Pirrone that it would serve no purpose since he had no assets and no money (274, 369, 492-93). Asked about his “credibility * * * (c)redit-wise,” he told Pirrone that he “couldn't obtain a loan because (he) had a bankruptcy a couple of years prior” (493).

31. During the course of the negotiations, Pirrone told Jack Martin that the inventory on hand had a value of $125,000 (551); that the equipment was worth between $50,000 and $75,000 (Id.); that the accounts receivable would bring about $48,000 (Id.); and that the work in progress would lead to a profit of approximately $60,000 (554). He also stated the real estate was worth $420,000 (551). Jack Martin accepted these figures; no inventory was ever taken (694). Pirrone also told

Martin that Vaniman's largest creditors would settle for half of what was owed them (550, 553-56).

32. At a meeting attended by James Martin, Pirrone, and Jack Martin sometime prior to August 2, 1979, Jack Martin was told that he would have to give security and James Martin suggested a second mortgage on the Vaniman property (273, 836). According to Jack Martin, Pirrone and James Martin wanted "(a) guarantee that they would be paid somehow and the only asset that Vaniman had then was the land and building, which had low money owing on it. In order to go ahead with the deal, they said I would have to have the (Vaniman) stocks held in escrow and take out a second mortgage on Vaniman" (836).

33. On August 1 or 2, 1979, Jack Martin, Pirrone, and James Martin signed a document entitled "Proposed Contract On the Sale of the Capital Stock of Vaniman International, ***173** Inc." ("Proposed Contract") (DX-M). The contract provided that on its signature, Jack Martin was to pay Vaniman $15,000, which would go to pay Robert Kral $10,000 and Pirrone $5,000 on the debts owed them by Vaniman (DX-M, P 1); that within thirty days thereafter, Jack Martin would purchase the outstanding stock of Vaniman for $125,000, payment to take the form of a seven-year note with interest at 13 percent (DX-M, P 2(a)); that he would pay in full the $46,500 due the Hempstead Bank (DX-M, P 2(b)); and that he would pay James Martin and Pirrone $33,857.63 owed them by Vaniman notes payable over five years with interest at 13 percent (DX-M, P 2(c)). The contract further provided that Jack Martin agreed that the deferred payments for the stock and on Vaniman's debts to James Martin and Pirrone would be "guaranteed by a second mortgage on the land and buildings of Vaniman" (DX-M, P 3).

34. When Jack Martin signed the Proposed Contract, he advised Pirrone that he would be unable to pay off the Hempstead Bank at the closing, as the contract provided (650-51, 843), but that it would be paid out of profits from the orders on hand (651).

35. At the signing of the Proposed Contract, Jack Martin gave Pirrone a check for $15,000 made out to Vaniman payable by Adventure Motor Homes Rentals (172-73, 372, 674), a trade name which Jack Martin had apparently started to use after Great Escape Motor Homes ceased to function (574-75). Of this money, $10,000 went to repay Robert Kral the money owed him, and the rest was used to meet Vaniman's current obligations to enable it to continue operating (278-79, 422).

36. On August 2, 1979, when Jack Martin signed the Proposed Contract, he also was shown a proposed four-year employment agreement between himself and Joseph Pirrone (653) which called for Pirrone to be employed as a consultant by Vaniman following the sale of the capital stock for a period ending December, 1983 at a salary of $24,000 and required Pirrone to be present at Vaniman on a daily basis (DX-G). Although Jack Martin agreed to these terms (499), he did not execute this agreement when he first saw it, signing it only in May or June, 1980 (499-500, 529-30, 653-54), but he paid Pirrone when cash was available the salary called for by the agreement (DX-O; 503-04, 811-12, 814).

E. The September 4, 1979 Documents

37. On September 4, 1979, the first business day following the close of business on August 31, 1979, a group of documents prepared by Vaniman's attorneys, Dean, Falanga, Sinrod & Rose, Esqs., were executed: "Purchase Agreement" (PX-1; DX-E), a mortgage (PX-2), a bond (PX-3), and a supplementary agreement (DX-F). All four documents were signed on behalf of Vaniman by Jack Martin, as president. The "Purchase Agreement" and the agreement supplementing it were signed also by James Martin, Jack Martin, and Pirrone, each in their individual capacity.

38. The Purchase Agreement is a complex document embracing a variety of "mutual representations, warranties and promises" (PX-1, at 1) among James Martin and Pirrone, referred to as the "Sellers," Vaniman, referred to as the "Guarantor" or the "Corporation," and Jack Martin, referred to as the "Purchaser" (Id.):

(1) The Sale of Stock. The agreement calls for the sale to the Purchaser of all shares of stock of Vaniman, but requires 51 percent to be held in escrow by the Sellers' attorneys as security for payment of their purchase price (P 2.3). The purchase price for the shares of the stock is stated to be $125,000 (P 2.1), payable in 84 equal monthly installments beginning October 1, 1979, with interest at 13 percent (P 2.2(a)).

(2) Life Insurance Policies. The "Purchase Agreement" provides that the Corporation is to transfer ownership to James Martin of an insurance policy it holds on his life in the principal amount of $52,500 (P 2.1.1(a)), to transfer to Joseph T. Pirrone a policy on his life in the amount of $25,000 (P 2.1.1(b)), and to surrender three other policies on the life of ***174** Pirrone and apply their cash values

against outstanding loans on the two transferred policies (PP 2.1.1(c) and (d)).

(3) Vaniman's Debts. Both Jack Martin and Vaniman acknowledge that Vaniman owes Pirrone $23,857.63, James Martin $10,000, and the Hempstead Bank $46,500 plus interest (P 2.2.1). Under the agreement, Vaniman undertakes to pay Pirrone and Martin the amount owed in sixty monthly installments beginning October 1, 1979 with interest of 13 percent (PP 2.2.3, 2.2.4). These payments are expressly excluded from the purchase price of the stock and are described as "a return of loans" (P 2.2.6). With respect to the debt owed the Hempstead Bank, the Purchase Agreement commits Jack Martin to loan Vaniman a sufficient sum at the closing to pay the Bank $46,500 plus interest (P 2.2.2(b)). Jack Martin also undertakes to lend the corporation $15,000, prior to closing, to repay Vaniman's indebtedness to Kral and part of its indebtedness to Pirrone (P 2.2.2(a)).

(4) Default. In the event of default by either Vaniman or Jack Martin in any of the deferred payments, all the notes are to become immediately due and payable at the option of the sellers (PP 2.2(d), 2.2.3, 2.2.4).

(5) The Second Mortgage. As security for all the payments called for by the Purchase Agreement, Jack Martin agrees to cause Vaniman "to execute and deliver to Sellers at the time of Closing, a second mortgage and mortgage Note in the principal sum of $158,857.00" in favor of Pirrone and Jack Martin (P 2.3.1). In the event of a default in the payment of any of the notes, the Sellers are given the right to declare the full amount due on the Second Mortgage and Mortgage Note payable immediately (P 2.3.2).

39. Jack Martin, on September 4, 1979, as President of Vaniman, executed a bond and mortgage, both in the amount of $158,857, mortgaging the building and real estate in which Vaniman did business, as called for by the Purchase Agreement (PXs-2 and 3).

40. Because Jack Martin did not have $46,500 on September 4, 1979 to lend Vaniman to pay the Hempstead Bank, a supplement to the Purchase Agreement bearing the same date was signed, under which Pirrone agreed to remain as guarantor on the note due the Bank for a period not to exceed six months, within which time Jack Martin agreed to comply with the Purchase Agreement by lending Vaniman sufficient money to repay the obligation (DX-F).

41. In accordance with the Purchase Agreement, Vaniman (a) surrendered certain life insurance policies owned by the debtor on the lives of Pirrone and Martin and caused payment of the cash surrender value to Pirrone, and (b) transferred to Pirrone and Martin certain other life insurance policies owned by the debtor on the lives of Pirrone and Martin (compare DX-C, at schedule 8 with DX-D). The cash surrender value of the policies surrendered (DXs-K, O) were:

		Cash Surrender Value
(1)	New York Life No. 33853980 Paragraph 2.1.1(c) of Purchase Agreement	$ 8,418.96
(2)	New York Life No. 32289326 Paragraph 2.1.1(d) of Purchase Agreement	1,665.62
(3)	New York Life No. 33099335 Paragraph 2.1.1(d) of Purchase Agreement	568.21

	Subtotal	$10,652.79

The cash surrender value of the policies transferred based on their value at the end of 1978 (PX-C, at schedule 8) were:

		Cash Surrender Value
(4)	New York Life No. 27700543 (Pirrone) Paragraph 2.1.1(b) of Purchase Agreement 12/31/78 surrender value	$ 526.08
(5)	Travelers No. 99045NW202 (Martin) Paragraph 2.1.1(a) of purchase Agreement 12/13/78 surrender value	1,857.33
	Subtotal	$ 2,383.41

42. Respecting the sale of the stock to Jack Martin, James Martin testified: "I sold my stock of Vaniman to Mr. John Martin. By so doing, it was my hope and intention that Vaniman would continue as an operating company. Mr. Pirrone and myself are getting along in years. The company needed new blood. It needed additional monies which Mr. Martin claimed ***175** that he was going to get for the company, either through himself or through others. It gave the company an outlook for the future and, again, young blood into the corporation" (Emphasis supplied) (883).

43. Neither Pirrone, nor Martin, believed that Jack Martin would be able to pay from his own resources the $125,000 to which he committed himself (187, 340-41). They knew that he expected to pay for the stock by borrowing money and by completing the orders which Vaniman had on hand (Id.), and that in order to do so, monies would have to be borrowed for labor and materials.

44. Apart from the $15,000 "loan" in August, 1979, Vaniman received no consideration for guaranteeing the payment by Jack Martin to James Martin and Pirrone for the purchase price of their stock, nor for so much of the bond and mortgage dated September 4, 1978 as constituted a security for such guarantee (194, 883). So much of the bond and second mortgage executed September 4, 1979 as exceeded $125,000 was supported only by the alleged antecedent indebtedness to James Martin and Pirrone.

45. Vaniman received nothing for the transfer of its interests in the life insurance policies it held on the lives of Pirrone and James Martin. The transfer of the insurance policies benefited only Pirrone and James Martin, not the debtor.

F. Vaniman's Financial Condition on September 4, 1979

46. On September 4, 1979, Vaniman's current liabilities exceeded its current assets by $223,990.78. Its current liabilities were $322,738.84, its current assets, $98,748.06 (DX-D, at schedules 1, 2). This meant that it had no working capital.

(1) Real Estate

47. The fair market value of Vaniman's real estate on September 4, 1979 was not more than $380,000. This was the figure at which the real estate had been appraised on March

1, 1978 by an expert for specialized use as a "truck repair operation" (DX-A) and was the figure adopted in Vaniman's financial statements for both 1977 and 1978 as the realty's market value (DXs-A and C, at schedule 1). In the year or more during which Vaniman's real estate had been on the market prior to September 4, 1979, the highest firm offer received for it was $375,000.

(2) Equipment

48. On September 4, 1979, Vaniman's equipment, including its factory and machinery, tools, office furniture, and automobiles had a maximum market value of $66,000 and was probably worth only a fraction of that figure. In Vaniman's 1977 financial statement, the figure of $66,000 is stated to be the "Total value of fixed assets, excluding real estate, according to appraisal made by Joseph T. Pirrone, President of the Company." (DX-A, at schedule 1, p. 3.)

49. Vaniman's general ledger (DX-L), as well as its financial statements (DXs-A, C, D) disclose that no money was spent for equipment of any character subsequent to 1977. Indeed, nothing was purchased after 1975. Thus, the equipment on hand on September 4, 1979 was the same equipment to which Pirrone and Vaniman had earlier assigned a maximum value of $66,000 (compare DX-A, schedules 6-1, 6-2, and 6-3 with DX-D, schedules 6-1, 6-2, and 6-3).[4]

***176** 50. While $66,000 is the maximum fair market value Vaniman's financial statements permit Martin and Pirrone to claim its equipment to have had as of September 4, 1979, this figure is indubitably higher than the true figure. All Vaniman's equipment at that time, including its three automobiles, was far from new. The supporting schedules which show the dates on which the individual items were bought show that all Vaniman's machinery and equipment, except one shop crane purchased in 1974, had been acquired no later than 1970 (DXs-A, C, D, at schedule 6-1); its three automobiles dated back to 1972, 1973, and 1975, respectively (DXs-A, C, D, at schedule 6-2); and all of its furniture and fixtures had been purchased no later than 1975, most of it much earlier (DXs-A, C, D, at schedule 6-3). According to Vaniman's records, the total cost of all the equipment on hand on September 4, 1979, including its three automobiles, was $73,434.57 (DX-D, at schedule 6). This is the same equipment to which Exhibit A assigns a fair market value of $66,000 (DX-A, at schedule 1). That after many years of use, the market value of used office machinery, shop equipment, and three automobiles had stayed so close to original cost appears most dubious. Indeed, if the three automobiles are subtracted, the fair market value assigned the balance of Vaniman's fixed assets exceeds their original cost.

51. It is not irrelevant that the sale on March 17, 1981 under the auspices of the bankruptcy court of all Vaniman's machinery and inventory brought in only $59,603.25 (DX-V), despite the fact that it included an item of equipment purchased subsequent to September 4, 1979 for $10,400 (1254-55, 1265-66).

52. However, certainly no higher market value can be claimed for Vaniman's equipment as of September 4, 1979 than Pirrone's own appraisal in 1977 of $66,000.

(3) Inventory

53. The inventory on hand on September 4, 1979 had a maximum fair market value of $58,000. This is the value assigned to it in Vaniman's financial schedule for the eight months terminating August 31, 1979 (DX-D, at schedule 1).

54. That Pirrone disclaims knowledge of the source of this figure is without significance because of the evaluation the Court has made of Pirrone's credibility. The evidence establishes that the source of the inventory figures in each of the preceding financial statements was Pirrone (297-98, 965-66, 968; page 2 of Brady letter in DXs-A, C) who testified that an inventory was taken at Vaniman on a regular monthly basis (297). It is a fair inference, therefore, despite Pirrone's disclaimer that he was, likewise, the source of the $58,000 figure. But whether he is or not, the Court deems this figure the most liberal valuation of inventory that the record will support.

55. The Court attaches no weight whatever to PX-6, which Pirrone completed the day before its introduction, purporting to show the inventory on hand and its value as of September 4, 1979 (1124). The circumstances of the preparation of this exhibit, the deliberate failure to bring to court the underlying documentation, and the evasiveness of Pirrone's answers when pressed as to what inventory figures he had available at the time of the exhibit's preparation, all deprive it of any probative value (957-1034, 1114-35).

56. Likewise, the Court deems of no probative value that Pirrone told Jack Martin that the inventory had a value of $125,000 (551, 694) and that Jack Martin did not question this value (693-94), even though he subsequently found the inventory to be virtually unsalable (842, 856).

57. According to Jack Martin, he was unable to use the inventory to raise funds for the operation of Vaniman because “(y)ou can't sell it. Nobody wants it” (842). ***177** The inventory was illiquid because there was little demand for stock as old as that which Vaniman had on hand. Martin testified that he told Pirrone when Pirrone pressed for payment that “we just didn't have any inventory to sell. * * * * We had nothing there. We had the rack bodies but most of it wasn't salable.” (841-42.) The rack bodies were not salable because the stock was old, some 10-, 15-, to 20-years-old (842).

58. Inventory which no one wants, whatever its cost, has only scrap value. Accordingly, crediting that inventory with a fair market value of $58,000 appears more than liberal.

(4) Accounts Receivable

59. The maximum value of Vaniman's accounts receivable as of September 4, 1979 was $32,305.86. This is the figure shown on DX-D, schedule 1. Like all the figures in DX-D, it probably overstates Vaniman's assets in that it deems only $10,000 of the total claimed, $42,305.86, to be uncollectible. In fact, only about $20,000 proved to be collectible (846-47), suggesting that DX-D overstated the value of accounts receivable by $10,000.

(5) Other Assets

60. In addition to the assets considered in the foregoing paragraph, Vaniman's financial statement for the eight months ending August 31, 1979 shows additional assets consisting of cash in the bank ($8,442.20) and credits for prepaid mortgage and insurance, totaling $4,801.48 (DX-D, at schedule 1).[5]

(6) Solvency

61. Based on the maximum fair market value earlier found, Vaniman's assets on September 4, 1979 totaled, at most, $549,550, composed of the following: real estate ($380,000), fixed assets, other than real estate ($66,000), inventory ($58,000), and accounts receivable ($32,306), cash ($8,442.20), and other assets ($4,801.48).

62. Vaniman's liabilities as of September 4, 1979, as reflected in its financial statement for the eight months ending August 31, 1979, were $533,259.51 (DX-D, at schedule 2). Accordingly, Vaniman's assets viewed most liberally slightly exceeded its liabilities. The surplus is $16,290.49. For the reasons given, however, it seems most unlikely that the fair market value of Vaniman's assets actually totaled $549,550 on September 4, 1979.[6]

63. When Vaniman increased its liabilities by $125,000 by placing a second mortgage on its real estate in the amount of $158,857, it converted the small surplus existing as of September 4, 1979 into a deficit in the neighborhood of $100,000. Increasing Vaniman's liabilities by $125,000 as the result of the guarantee, bond, and mortgage executed on September 4, 1979 rendered it insolvent. Its liabilities rose as a result to a total of $658,259.51, while its assets were only $549,550.

G. Post-1979

64. Subsequent to September 4, 1979, Pirrone continued to occupy the same office on Vaniman's premises as he had done previously, remaining there until August or September, 1980 (348). He continued to receive mail and telephone calls at Vaniman (348-49); he assumed the office of Vice-President of Vaniman (190, 361); and he remained a signatory on the account with the Hempstead Bank until mid-1980 (361).

65. To permit Vaniman to continue operating and to pay wages, Pirrone borrowed ***178** $25,000, which has never been repayed (719), from Kral and other Vaniman employees (506-08, 712-18). After Jack Martin became the owner of Vaniman's stock, he increased its payroll and built an additional office which may have increased Vaniman's financial difficulties (330, 702-03).

66. On October 3, 1979, Pirrone, represented by Anthony Falanga, Esq., appeared before Judge Whitman Knapp to plead guilty to giving false testimony to a Grand Jury and violating 18 U.S.C. s 1623. Pirrone's counsel told the Court that the Ford transaction has been entered into “to protect the business (Pirrone) had had for so many years that was in financial difficulty.” (DX-R, at 14.) On October 28, 1980, Pirrone received a suspended sentence and was put on probation for five years for violating 18 U.S.C. s 1623 (DX-T).

67. To find money with which to pay James Martin and Pirrone, Jack Martin endeavored to interest various potential investors (708-12). The group with which Margaret Janaskie was associated ultimately gave Jack Martin approximately $66,000 between November, 1979 and April, 1980, all of which went into the corporate checking account (709-12,

723). Out of the monies which Jack Martin received in December, 1979, he paid the notes due Pirrone and Martin for October, November, and December (709), and also paid Pirrone some amounts on account of salary. Pirrone received a total of $8,271.77 in December, 1979 and January, 1980 on his notes (DX-O), and $3,150 on account of salary (DX-O).

68. In connection with Jack Martin's efforts to raise money by selling his stock or borrowing funds, James Martin and Pirrone, on December 27, 1979, signed an amendment to the September 4, 1979 Purchase Agreement authorizing release of the Vaniman stock from escrow (DX-I; 726-27, 817-19). In March, 1980, Pirrone authorized John F. Brady to make Vaniman's 1979 financial statement available to Jack Martin to show potential investors (533-46).

69. On May 12, 1980, Margaret Janaskie, who had acquired a majority of the outstanding shares of Vaniman's stock, ordered Jack Martin off the premises (242, 528). In light of this development, James Martin and Pirrone were able to persuade Jack Martin to sign both the employment agreement dated August 2, 1979 (DX-G), and a second one dated February 1, 1980 (DX-H), between Vaniman and Pirrone (529-30). The February 1 agreement was similar to the earlier agreement, except Pirrone's salary was increased to $36,000 from $24,000, and the agreement itself was conditional on the carrying out of the September 4, 1979 agreement.[7] Although Jack Martin still held the title of president, his authority to sign the agreement is questionable (532).

70. During the period Jack Martin operated Vaniman, he deducted withholding taxes from the wages paid his employees, but failed to pay over these taxes to the appropriate authorities (509, 815-16).

71. Although Pirrone had talked of immediate foreclosure proceedings when Jack Martin first fell behind on his payments on October 1, 1979 (841), and an attorney was engaged by James Martin and Pirrone in March or April, 1980 for that purpose (365), no action was taken until the Hempstead Bank satisfied the $46,500 debt owed it by Vaniman by setting that figure off against monies which became due Vaniman around June 24, 1980 under a bank letter of credit. The Hempstead Bank had started pressing hard for payment after a judgment creditor just before Christmas attached Vaniman's bank account at that bank (359, 511-12, 516; PXs-7-10). Pirrone had pointed out to the bank that funds would become available ***179** to Vaniman under a letter of credit when it completed an outstanding contract (357, 362, 364), and when this occurred, the bank offset the debt against the monies owed Vaniman, draining it of operating capital (1055-58; DX-U).

72. In or about June, 1980, James Martin and Pirrone brought a proceeding in the state court to foreclose their second mortgage on Vaniman's realty (Plaintiffs' Proposed Findings of Fact, P 11).

73. Within a month, on July 11, 1980, the debtor filed a petition under Chapter 11 of Title 11 of the United States Code. In September, 1980, Pirrone and Martin initiated the instant proceeding seeking relief from stay so that they could pursue their foreclosure proceeding in the state court. Relief from the automatic stay imposed by 11 U.S.C. s 362 was also sought by the holder of the first mortgage of Vaniman's real estate, Roslyn Savings Bank. At a hearing on Roslyn's application on October 15, 1980, Roslyn called an expert witness, J. Robin Newbold, who testified that the value of the Vaniman real estate was approximately $360,000.[7a] Counsel for Martin and Pirrone requested that this testimony be deemed applicable in their proceeding against the debtor.[7b]

74. On October 31, 1980, by consent, the debtor's Chapter 11 reorganization was converted to a Chapter 7 liquidation and on November 21, 1980, Leonard Toboroff, the defendant herein, was duly elected permanent trustee and has qualified, and is presently acting in that capacity.

75. Toboroff sought and received authority to sell the Vaniman realty with all liens to attach to the proceeds. On February 24, 1981, the real property owned by Vaniman was sold through the bankruptcy court for $535,000 (1288-90). The successful bidders were persons associated with Bucknell Press, Inc., which had previously sought to buy the land and building.

H. Miscellaneous Findings

76. Pirrone was not a credible witness; his answers were not characterized by candor; without adequate explanation he repudiated his answers on his deposition, which he had earlier gone over and corrected; he was evasive; and many of his answers were incomplete and misleading.

77. Likewise, James Martin appeared to be less than candid, giving evasive-and what the Court has concluded must be deemed untruthful-answers where his self-interest was involved.

I. Vaniman's Financial Statements

78. For a period of at least ten years ending with his death sometime after May, 1980, John F. Brady, a certified public accountant, prepared annual financial statements for Vaniman (69, 85-97, 377-78, 494-95, 863-72; DXs-A, C). At the request of Pirrone (100-03), he prepared a financial statement for the eight months ending August 31, 1979 (DX-D).

79. The annual financial statements indicate that the figures for merchandise inventory and work in progress, and for accounts receivable, were supplied by Pirrone and Vaniman employees (85, 297-98, 788, 794-97, 965-68, 1121; page 2 of Brady letters in DXs-A and C). All of the figures in the 1978 financial statement (DX-C) can be tied in and traced back to Vaniman's general ledger (792; DX-L0, and all the figures in the financial statement for the eight months ending August 31, 1979 (DX-D) can also be so tied in and traced, except the entries in the financial statement relating to the officers' loan accounts, including the transfer of certain life insurance policies (schedule 2-1B), the value of the inventory on hand as of August 31, 1979 (schedule 3-1), and certain other minor entries (784-87, 793-94).

***180** 80. It can fairly be inferred that the figure for inventory in the financial statement for the eight months ending August 31, 1979 was supplied by Pirrone in accordance with previous practice (796-97).

81. Although Brady spent relatively little time in later years at Vaniman's premises, the statements he prepared were of reasonably good quality from an accounting standpoint (787-88).

82. It was part of Vaniman's contract with Brady that he provide annual financial statements and they were received by Vaniman in the regular course of its business (864-69).

83. Vaniman supplied the financial statements prepared by Brady to banks (75-83; DX-N) and potential investors (420-21), in addition to Cote (Finding 28, supra), Jack Martin (123, 479-80, 642; P 3.3.1 of PX-1), and Omega Air Carriers (536-44).

84. Prior to the trial herein, John F. Brady died (69).

J. Bribery

85. There is no evidence that any creditor at the time the petition herein was filed was owed a debt contracted by Vaniman in 1976 or earlier.

DISCUSSION

I.

THE FRAUDULENT CONVEYANCE CLAIMS

In Rubin v. Manufacturers Hanover Trust Co., 661 F.2d 979 (2d Cir. 1981), Circuit Judge Kearse, writing for a unanimous court, described as follows the soil from which fraudulent conveyances grow:

> "When an overburdened debtor perceives that he will soon become insolvent, he will often engage in a flurry of transactions in which he transfers his remaining property, either outright or as security, in exchange for consideration that is significantly less valuable than what he has transferred. Although such uneconomical transactions are sometimes merely final acts of recklessness, the calculating debtor may employ them as a means of preferring certain creditors or of placing his assets in friendly hands where he can reach them but his creditors cannot. Whatever the motivation, the fraudulent conveyance provisions of s 67(d) of the Bankruptcy Act, 11 U.S.C. s 107(d), recognize that such transactions may operate as a constructive fraud upon the debtor's innocent creditors, for they deplete the debtor's estate of valuable assets without bringing in property of similar value from which creditors' claims might be satisfied." 661 F.2d at 988-89.

Although s 67d of the Bankruptcy Act has been replaced by s 548 of the Bankruptcy Code, 11 U.S.C. s 548, Judge Kearse's observations have not lost their pertinence. Where insolvency is imminent, or has already been reached, what men seek to do is to remove their assets from the reach of their creditors and preserve them for their own enjoyment. This is precisely what occurred here.

Had Vaniman sold its real estate and liquidated its assets in the summer of 1979, it is probable that not enough would have been realized to pay its creditors, leaving its stockholders with nothing. It was in this context that Pirrone and James Martin, the two men in control of Vaniman, arranged to give themselves a preferred claim to Vaniman's equity in its real property and to acquire for their own benefit the life insurance policies held by Vaniman on their lives.

All this was engineered through the medium of a sale of all the outstanding stock of Vaniman to Jack Martin, a penniless young man with nothing to lose. Had Martin and Pirrone, on September 4, 1979, gratuitously placed a second mortgage on the Vaniman property in their own favor, the lien would not have been good as against the creditors of Vaniman. Martin's and Pirrone's ownership of Vaniman would have given them no more right to put a mortgage on Vaniman's property for their own benefit when that company was in financial difficulties, giving Vaniman nothing ***181** in exchange, than to take money out of Vaniman's till and put it in their own pockets. Martin was simply a vehicle through which Martin and Pirrone did indirectly what they could not do directly.

What occurred here represents exactly the type of conduct which the law against fraudulent conveyances is designed to prohibit; placing the assets of a financially ailing corporation where insiders can reach them, but creditors cannot. Repeatedly, the courts have had occasion to condemn as fraudulent conveyances security interests which insiders have acquired in the assets of a financially-ailing corporation under circumstances similar to those present here. M. V. Moore & Co. v. Gilmore, 216 F. 99 (4th Cir. 1914); In re Atlas Foundry Co., 155 F.Supp. 615 (D.N.J.1957); Duberstein v. Werner, 256 F.Supp. 515 (E.D.N.Y.1966); In re Roco Corp., 15 B.R. 813, 8 B.C.D. 582, 5 C.B.C.2d 921 (Bkrtcy., D.R.I.1981). See also In re College Chemists, Inc., 62 F.2d 1058 (2d Cir. 1933); Lytle v. Andrews, 34 F.2d 252 (8th Cir. 1929).

II.

THE RELEVANT STATUTES

The trustee in bankruptcy is invoking 11 U.S.C. ss 544 and 548.

Section 548 replaces s 67d of the Bankruptcy Act, which, in turn, was derived largely from the Uniform Fraudulent Conveyance Act.[8] Only transfers made within one year of the date of the filing of the petition may be challenged under s 548. Subsection (a) of s 548 consists of an introduction followed by four substantive paragraphs which replace the substance, respectively, of ss 4, 5, 6, and 7 of the Uniform Fraudulent Conveyance Act. 4 Collier on Bankruptcy P 548.02(1), at 548-22 (15th ed. 1982).[9]

Section 544 of the Code imports state law into the Code and gives the trustee in bankruptcy " 'every right and power which is conferred by the law of the state upon its most favored creditor who has acquired a lien by legal or equitable proceedings.' " 4 Collier on Bankruptcy P 544.02, at 544-5, quoting In re Waynesboro Motor Co., 60 F.2d 668, 669 (S.D.Miss.1932) (Holmes, J.).

In 1925, New York adopted the Uniform Fraudulent Conveyance Act, which is now to be found in ss 270-281 of the Debtor and Creditor Law of New York. These provisions parallel 11 U.S.C. s 548(a), but go further and authorize the recovery of reasonable attorneys' fees where a conveyance is found to have been "made by the debtor and received by the transferee with actual intent, as distinguished from intent presumed in law, to hinder, delay or defraud * * * creditors." New York Debtor and Creditor Law s 276-a. A trustee in bankruptcy is specifically named in the New York statute as entitled to recover such attorneys' fees. Id.

Both state and Federal law make voidable any transfer accomplished with an actual fraudulent intent. Both also make vulnerable transfers for less than a reasonably equivalent value under certain conditions, despite lack of an actual intent to defraud. A transfer for less than a reasonably equivalent ***182** value is fraudulent when the debtor "was insolvent" on the date the transfer was made or became insolvent as a result (11 U.S.C. s 548(a)(2)(B)(i); Debtor and Creditor Law s 273), or was engaged in business for which any property remaining "was an unreasonably small capital" (s 548(a)(2)(B)(ii); Debtor and Creditor Law s 274), or intended to incur debts that would be beyond the debtor's ability to pay as such debts matured (s 548(a)(2)(B)(iii); Debtor and Creditor Law s 275).

Under all four tests, the creation of a second mortgage and the transfer of the life insurance policies constitute fraudulent conveyances.

III.

FRAUDULENT INTENT

By necessity, fraudulent intent is not susceptible of direct proof. As Judge Edward Neaher has pointed out in an analogous connection:

> “The analysis begins with a statement of the obvious. Persons whose intention it is to shield their assets from creditor attack while continuing to derive the equitable benefit of those assets rarely announce their purpose. Instead, if their intention is to be known, it must be gleaned from inferences drawn from a course of conduct. In re Saphire, 139 F.2d 34, 35 (2 Cir. 1943); In re Freudmann, 362 F.Supp. 429 (S.D.N.Y.1973), aff'd, 495 F.2d 816 (2 Cir. 1974).” In re Vecchione, 407 F.Supp. 609, 615 (E.D.N.Y.1976).

Furthermore, as this Court noted in In re Checkmate Stereo and Electronics, Ltd., 9 B.R. 585, 612 (Bkrtcy.E.D.N.Y.1981), mod. and aff'd, 21 B.R. 402 (E.D.N.Y.1982):

> “The facts are not to be atomized. Where a transfer is only a step in a general plan, the plan ‘must be viewed as a whole with all its composite implications.’ Buffum v. Peter Barceloux Co., 289 U.S. 227, 232, 53 S.Ct. 539, 541, 77 L.Ed. 1140 (1933); Shapiro v. Wilgus, 287 U.S. 348, 353, 53 S.Ct. 142, 143, 77 L.Ed. 355 (1932). A ‘clear pattern of purposeful conduct’ will support ‘a finding of actual intent to defraud.’ In re Freudmann, 495 F.2d 816, 817 (2d Cir. 1974), cert. denied sub nom. Freudmann v. Blankstein, 419 U.S. 841, 95 S.Ct. 72, 42 L.Ed.2d 69 (1974).” 9 B.R. at 612-13.

The authoritative text on bankruptcy, Collier on Bankruptcy, states that “the finding of the requisite intent may be predicated upon the concurrence of facts which, while not direct evidence of actual intent, lead to the irresistible conclusion that the transferor's conduct was motivated by such intent. Rarely will a fraudulent transferor disclose his fraudulent intent in a mode capable of direct proof. Unless the clause (s 548(a)(1)) is to have a severely restricted scope, it would seem to cover cases where the trustee shows that the transferor acted under circumstances that preclude any reasonable conclusion other than that the purpose of the transfer was fraudulent as to his creditors.” 4 Collier on Bankruptcy P 548.02(5), at 548-33-34.

Among the badges of fraud are “the existence of an unconscionable discrepancy between the value of property transferred and the consideration received therefor * * * (or) the fact that the transferee was an officer or was an agent or creditor of an officer of an embarrassed corporate transferor.” Id. at 548-37-38. Where the transferee is in a position to dominate or control the debtor's disposition of his property, the transferee's intent to hinder, delay, or defraud creditors may be imputed to the debtor. 4 Collier on Bankruptcy P 548.02; In re Roco Corp., supra, 15 B.R. at 817, 8 B.C.D. at 585, 5 C.B.C.2d at 927-28.

In mid-1979, Vaniman was in grave-and probably terminal-financial difficulty. At the time of the transaction here involved, it had been losing money on its operations for over two years; it owed its last successful year to a contract secured through commercial bribery; its chief executive officer would shortly plead guilty to perjury; in order to pay its real estate taxes and meet its payroll, it had been forced to borrow money from its stockholders and an employee; and many of its creditors had not been paid for over a year.

***183** Its liabilities were many, and its assets were few and far from liquid. Its biggest asset was the real estate from which it conducted its business: the building and the land on which it stood. Vaniman's inventory, while valuable, was not salable; its accounts receivable turned out to be only partially collectible; and most of its machinery and equipment was many years old.

Vaniman's troubles were not of recent origin, nor its causes past: Vaniman's sales had been declining steadily for a period of two years, and Vaniman was being adversely affected by the poor market for vehicles generally. Also, it could not but be hurt by the involvement of its chief executive officer in an investigation of commercial bribery.

Pirrone and James Martin, knowing better than anyone else how desperate the situation of Vaniman was, used their control over the corporation to obtain for themselves what assets remained to Vaniman. This was a clear abuse of their position, making what they did fraudulent as to creditors and voidable by the trustee in bankruptcy.

When James Martin, a man whose expertise lay in finance, arranged for the placement of a second mortgage in favor of himself and Pirrone on the single significant asset of the corporation which they jointly controlled, both men necessarily knew that what they were doing would take Vaniman's assets out of the reach of Vaniman's creditors and preserve those assets for themselves, and they intended this result.

The lameness of the explanation offered by James Martin for the use made of Jack Martin negates any other view of the facts. According to James Martin, he and Pirrone were tired and wished, for personal reasons, to relinquish to a younger and more vigorous man the operation of the enterprise they had been jointly conducting (883). But, under the employment agreement which Pirrone's lawyers drew up as part of the sale to Jack Martin, Pirrone committed himself to appear at Vaniman's premises on a daily basis without even vacation periods, doing what he had always done for Vaniman. Indeed, every indication from the record is that the transactions of September 4 made no difference whatsoever in Pirrone's involvement with Vaniman: he continued to occupy the same office, solicited orders, borrowed money, and acted as signatory on the checking account. To describe the events of September 4, therefore, as being the result of an effort to disengage James Martin and Pirrone from the obligations of management is inconsistent with the facts.

Nor is there any more substance to the implication that the purpose was to benefit Vaniman and restore it to health. As both men had more reason to know than anybody else, what this required, above all, was an infusion of new money which Jack Martin, a penniless young man with a negative credit rating, was peculiarly unable to secure. Furthermore, it could not but have been evident to these two experienced businessmen that Jack Martin, with his limited education and experience, was wholly incapable of taking over the reins of management, and could only lead Vaniman into further difficulties. Jack Martin to his credit frankly acknowledged on the witness stand his total lack of qualifications, manifested several times in his answers to questions probing events during the period he theoretically was in control of the company.[10]

***184** Not only did Pirrone and Martin put an unqualified man at the helm of Vaniman, but they simultaneously stripped it of possible sources of the capital it needed to operate by transferring to themselves the life insurance policies which had some surrender value, and by creating a second mortgage on Vaniman's real estate, thereby foreclosing from Vaniman the ability to raise the capital by mortgaging that property itself in return for additional financing.

In evaluating the intent underlying the transactions which took place on September 4, 1979, events subsequent to that date are also relevant.

The demise of Vaniman was virtually assured when James Martin and Pirrone, after the Hempstead Bank loan was paid, brought on their proceeding to foreclose the mortgage they held on Vaniman's real estate. When Vaniman turned to the bankruptcy court for relief, they terminated whatever small chance Vaniman might have had to rehabilitate itself by seeking relief from stay so they could proceed to foreclose the mortgage they held on the real estate, without which Vaniman could not operate.

Nothing in their actions has been consistent with the desire to preserve Vaniman as a going enterprise and protect its creditors; everything both men have done demonstrates a determination to salvage for themselves, without regard to the rights of creditors, what little Vaniman had in the way of assets on September 4, 1979.

Although fraudulent intent is a matter of fact and no two cases are exactly alike, such intent has been found by other courts in circumstances very similar to those present here, where a transferee in a position to dominate or control the debtor's disposition of its property has arranged for the corporation to incur an obligation many times greater than any benefit received, the result of which was the corporation's insolvency. Duberstein v. Werner, supra, 256 F.Supp. at 520; In re Roco Corp., supra, 15 B.R. at 817, 8 B.C.D. at 585, 5 C.B.C.2d at 927.

In Duberstein v. Werner, supra, 256 F.Supp. at 520, District Judge Bartels found an intent to hinder, delay, and defraud existing and future creditors of the corporation there involved, Raywal, Inc., in the execution and delivery of a chattel mortgage to a controlling stockholder, officer, and director "to secure an antecedent debt of doubtful legitimacy at a time when the corporation was insolvent and when he had knowledge of that fact." The facts here are even stronger, since the mortgage was issued primarily to secure a debt that was not even that of the corporation, but was created simultaneously with the execution of the mortgage. Whether or not technical insolvency has been proved beyond peradventure, Vaniman was a basket case on September 4, 1979, as no one knew better than the two men who arranged this non-arm's-length transaction.

In re Roco Corp., supra, involved a sale of all the issued and outstanding capital stock of Roco back to the corporation, in exchange for which Roco issued its promissory note for $300,000, plus a second note for a prior loan. As collateral for both loans, Roco gave the sellers a security interest in Roco's receivables, inventory, and equipment. The same date, the son of the two stockholders purchased from the corporation for $3,000 one share of its stock, thereby becoming its sole stockholder and also its only officer and director. Due to mismanagement, the corporation went into bankruptcy. The former stockholders then brought an action seeking relief from the automatic stay so they could foreclose on their security interest. The bankruptcy court, after pointing out that Roco incurred an obligation ($300,000) one hundred times greater than the benefit received ($3,000), continued:

> "The negotiations leading to this obligation and transfer were not at arm's length, and the result of these dealings was Roco's insolvency. Based on these facts, the court concludes that the execution of the $300,000 note was an effort to ***185** hinder, delay or defraud Roco's creditors and was therefore a fraudulent transfer." 15 B.R. at 817, 8 B.C.D. at 585, 5 C.B.C.2d at 927-28.

Where a conveyance is made with actual intent to hinder, delay, or defraud creditors, it is not necessary to show that the debtor was insolvent for the conveyance to be voidable as fraudulent. This is as true under the Code and New York's present statute, as under prior law. Vollkommer v. Cody, 177 N.Y. 124, 130, 69 N.E. 277 (1904); Carstairs v. Spear, 201 A.D. 418, 421, 194 N.Y.S. 134 (1st Dep't 1922).

Whichever of Vaniman's assets were conveyed to James Martin and Joseph T. Pirrone after August 1, 1979, and whatever obligations were incurred by Vaniman toward these men, were tainted by being part of the same overall scheme to hinder, delay, and defraud the creditors of Vaniman. Accordingly, equity requires that everything that was done be undone.

IV.

CONSTRUCTIVE INTENT

The mortgage and the various transfers to James Martin and Joseph T. Pirrone were fraudulent conveyances, even if intent to defraud had been lacking, because they were all constructively fraudulent. Vaniman received no consideration for its undertaking to guarantee the payment of $125,000 to Martin and Pirrone for their stock; it received no consideration for the transfer to Martin and Pirrone of the insurance policies on their lives; except for the fact that there allegedly existed antecedent debts to Martin and Pirrone in the amount of $33,857.63, Vaniman received no consideration for the second mortgage it gave these men in the amount of $158,857. In the words of the Code, Vaniman received "less than a reasonably equivalent value" in exchange for the property transferred and the obligation incurred. 11 U.S.C. s 548(a)(2)(A). The "value of what the bankrupt actually received was disproportionately small compared to the value of what it gave." (Emphasis in original.) Rubin v. Manufacturers Hanover Trust Co., supra, 661 F.2d at 993. The result was that Vaniman (a) became insolvent (s 548(a)(2)(B)(i)), (b) was left with an "unreasonably small capital" for the business in which it was engaged (s 548(a)(2)(B)(ii)), and (c) would necessarily incur "debts that would be beyond the debtor's ability to pay as such debts matured" (s 548(a) (2)(B)(iii)). Since the transfers were made, and the obligations all incurred, within one year before the date of the filing of Vaniman's petition under Title 11, they are all fraudulent transfers and obligations as a matter of law.

Vaniman was rendered insolvent because increasing its liabilities on September 4, 1979 by $125,000 resulted in its liabilities exceeding its assets. This is the test of insolvency, both under the Code (11 U.S.C. s 101(26)) and the New York Debtor and Creditor Law s 271(1). The Code defines "insolvent" as a financial condition in which the sums of an entity's debts is greater than that of "all of such entity's property, at a fair valuation." 11 U.S.C. s 101(26) (A). The term "fair valuation" appears to be synonymous with the Act's "present fair salable value" of a debtor's property (s 67d(1)(d)), which the Second Circuit has held to mean "market value." Rubin v. Manufacturers Hanover Trust Co., supra, 661 F.2d at 995.

Placing the most generous value on Vaniman's assets, it was barely solvent prior to the creation of the second mortgage on its property. That mortgage, by increasing its liabilities by $125,000, plunged it into insolvency. Therefore, both under the Code, and under New York Debtor and Creditor Law, whatever was transferred to Martin and Pirrone subsequent to September 4, 1979, except whatever salary was paid Pirrone, was in fraud of creditors.

In fact, it was not necessary for the trustee to prove that Vaniman was rendered insolvent, if it was not already insolvent, by the events of September 4, 1979. The transfer of the life insurance policies and the creation of a second mortgage at least to the extent of $125,000 were entirely gratuitous. As the Second Circuit noted in ***186** Feist v. Druckerman, 70 F.2d 333, 334 (2d Cir. 1934):

> "Now, there is a rule of long standing in the New York courts that a voluntary conveyance made when the grantor is indebted is presumptively fraudulent. We think this means that, if one indebted makes such a transfer, it is presumed, in the absence of some proof to the contrary, that he was then insolvent." (Emphasis in original.)

Among the cases cited by the Second Circuit was Ga Nun v. Palmer, 216 N.Y. 603, 611-12, 111 N.E. 223 (1916), in which Judge Cardozo wrote:

> "The rule is that a transfer without consideration by one who is then a debtor raises a presumption of fraud. The creditor may stand upon that presumption until it is repelled. It is not for him to show what other property was retained. * * * The transfers may, of course, have been fraudulent even though there was a consideration. Their validity turns then upon the intent with which they were given or received. If, however, there was no consideration, the fraudulent purpose, in the absence of explanation, is an inference of law." (Citations omitted.)

James Martin and Pirrone failed to prove that Vaniman was solvent on September 4, 1979. They gave no explanation for the voluntary transfer to them of the life insurance policies, nor any adequate explanation for the creation of a second mortgage. On these grounds, therefore, as well, the trustee is entitled to prevail.

Independent of the fact that the September 4, 1979 transaction rendered Vaniman insolvent, it also left the corporation with an unreasonably small capital and put it in a position in which it would necessarily incur expenses it could not meet.

Placing a second mortgage on Vaniman's real estate left Vaniman with a minus capitalization. It closed off the one possible source of funds to a company whose current liabilities far exceeded its current assets. Necessarily, therefore, the transaction left Vaniman with inadequate capital.

Four-square authority establishing the fraudulent character of the plaintiffs' second mortgage is In re College Chemists, Inc., 62 F.2d 1058 (2d Cir. 1933), which also answers plaintiffs' contention that Vaniman's capital was not depleted by the second mortgage because no transfer of cash was involved. There, the sole stockholder, Diller, sold all his stock to one Weiner, taking back as security a chattel mortgage on all the corporation's assets. The assets had a value of less than the purchase price. Subsequently, the corporation went into bankruptcy. The Second Circuit affirmed the conclusion reached by the bankruptcy referee that the security interest was voidable, under s 274 of the Debtor and Creditor Law of New York, one of the statutes relied on by the trustee in this proceeding. The Court said:

> "The property remaining in the bankrupt's hands was 'an unreasonably small capital'; indeed there was no capital at all, because Weiner's debt was more than its value. There was indeed a consideration to support the contract as between Diller and Weiner, Diller's transfer of the shares to him; but this was not a 'fair consideration' under section 272. The consideration must be 'in exchange' for the property conveyed. The bankrupt did not, and of course could not, receive its own shares in exchange for its property. The shares passed to Weiner, and the result of the transaction was merely to give back to Diller the whole capital of the corporation, allowing Weiner to carry on the business on an expectancy of profit." 62 F.2d at 1058.

Similarly, in this case, the second mortgage left Vaniman with "no capital at all," with the result that Jack Martin thereafter was doing no more than "carry(ing) on the business on an expectancy of profit," an expectancy which, in light of Vaniman's record, was wholly illusory. Section 274 of New York's Debtor and Creditor Law parallels s 548(a)(2)(B)(ii) of the Bankruptcy Code.

James Martin and Pirrone also knew when they arranged the transfer of the life ***187** insurance policies and the creation of a second mortgage that Vaniman would be incurring debts that it could not meet. Since Jack Martin had no assets or credit of his own, he could only pay James Martin and Pirrone in accordance with the Purchase Agreement out of the resources of Vaniman. He either had to generate funds by completing the contracts on hand, or borrow money, or do both. For Vaniman to complete its contracts, it would have to incur obligations for materials and labor. Both James Martin and Pirrone knew from Vaniman's losses during the preceding two years that Vaniman would be unable to repay these obligations. What has occurred is exactly what could have been expected. Vaniman, in order to complete the contracts on hand, borrowed money from its employees, which has never been repaid. It has failed even to remit the taxes it withheld from its employees' wages. These subsequent creditors are the intended beneficiaries of the law here involved.

In holding the September 4, 1979 transactions to constitute fraudulent conveyances, this Court is not breaking any new ground. The precedents are many and far from recent. In M. V. Moore & Co. v. Gilmore, 216 F. 99 (4th Cir. 1914), the bankruptcy court was sustained in disallowing three notes and a deed of trust given to secure their payment under circumstances similar to those present here. There, the corporation, at a time when its assets were just in equilibrium with its liabilities, but it was experiencing grave financial difficulties, bought back his shares from a majority shareholder for $2,000, of which $1,500 consisted of notes secured by a deed of trust covering all its assets. Three months later, the corporation was adjudicated a bankrupt. The Fourth Circuit held the mortgage and the notes to be void as arising from a transaction which was fraudulent as to creditors as a matter of law:

> "The vice of the transaction under review is not found in dishonest intention on their (the buyer and seller of the majority stock) part, but in the distressed situation of the company which operated as a matter of law to make what they did a fraud upon creditors. Without adding a dollar to the assets they increased the liabilities some 20 per cent, and got security for the debt so created by a pledge of all the property of the corporation. The necessary effect of this arrangement was to make the concern hopelessly insolvent. The stock they parted with was valueless, and the notes they took had no valid consideration.
>
> "To uphold the transaction here disclosed, however free from moral delinquency, and thereby give preference over other creditors to these majority stockholders whose debt is the purchase price of their own shares sold to the corporation itself, when its condition was manifestly precarious, to say the least, would be so contrary to good conscience and common sense that no argument is needed to show that it ought to be condemned. The members of appellant's firm were bound to know, as the event proved, that the concern was on the verge of failure, and the law forbade them to deplete the assets, which belong in equity to the creditors, for the purpose of recovering some part of an otherwise lost investment." 216 F. at 101.

The facts here are similar to, but even more egregious than, those present in In re Atlas Foundry Co., 155 F.Supp. 615 (D.N.J.1957). Before the District Court for review in that case was an order by the referee in bankruptcy adjudging a mortgage invalid as against the bankrupt's trustee. As the referee phrased the question for review, it was:

> "May stockholders of a corporation, through use of a fictitious consideration, obtain a mortgage on the realty of the corporation as part consideration for the sale of their shares of stock in the corporation?" 155 F.Supp. at 616.

To this question, the court answered with a strong and sharp negative. Yet, from the viewpoint of the trustee, the facts in that case were far weaker than those present here. The corporation there involved was cash rich, and there is no indication from the record that it was insolvent prior to the ***188** sale of its stock by their shareholders, a single family, named Bornstein. Like Jack Martin in this case, the purchaser there, a corporation, C. A. Goldsmith Company, and its stockholders, Ehrlich and Goldfinger, had no funds, and used the assets of Atlas to finance the acquisition. What Goldsmith did was borrow $250,000 which it then lent to Atlas, receiving back a note and a mortgage in this amount. This note and mortgage then became part of the $650,000 paid the former stockholders for their stock. As soon as the new owners succeeded to the stock, they withdrew the amount earlier lent Atlas, and repaid the bank from which the money had originally been procured. They further reduced Atlas' bank balance in order to repay the balance of the monies which they had borrowed to finance the purchase. These transactions "so burdened Atlas with debts and so weakened its cash position that some form of insolvency proceeding became inevitable and on December 23, 1953 it filed a petition for an arrangement under Chapter XI of the Bankruptcy Act." 155 F.Supp. at 617. As in this case, the Chapter 11 was soon succeeded by an adjudication in bankruptcy and the sale of the real estate subject to the mortgage, leaving for decision the validity of the lien of the former owners. District Judge Wortendyke, after summarizing these facts, continued:

> "The Referee correctly concluded that the mortgage in question is invalid against the Trustee of the bankrupt because its execution by the bankrupt and acquisition by the present holders was achieved with the knowledge and collusive cooperation of such holders by way of circumvention of the legal obstacle prohibiting the bankrupt from mortgaging its assets to pay its stockholders for their stock." Ibid.

Indeed, in this case, the bankrupt did mortgage its assets to pay its stockholders for their stock. Moreover, Atlas was not insolvent, and did not become insolvent "until after the mortgage was executed, delivered and assigned" (155 F.Supp. at 618), and would not have become insolvent but for the deliberate depletion of its assets by the purchasers. In this case, Vaniman became insolvent as soon as the mortgage was executed, as James Martin and Pirrone necessarily knew, so that the creation of a lien on Vaniman's sole asset was necessarily in fraud of creditors. In terms of Atlas, this is an a fortiori situation.

The controlling principles were succinctly stated by the highest court of the State of New York more than one hundred years ago in Carpenter v. Roe, 10 N.Y. 227 (1851), involving the transfer by a produce merchant of certain real estate to his wife shortly before he became insolvent in consequence of a sudden fall in the price of grain. Holding the deed to Roe's wife to be void as in fraud of creditors, the Court of Appeals said:

> "To avoid the conveyance and trust to and in favor of his wife, it was not necessary that the debtor should be insolvent, or believe himself to be so, when they were executed or created. It was sufficient, that he was indebted, and that insolvency would be the inevitable or probable result of want of success in a business in which he was engaged. He could not, legally or honestly, in this manner provide for himself or family, and cast upon his creditors the hazard of his speculation." 10 N.Y. at 231-32.

V.

PREFERENTIAL TRANSFER

A. The Relevant Statutes

Section 547 of the Code authorizes a bankruptcy trustee to avoid any transfer of property of the debtor for the benefit of a creditor on account of an antecedent debt made while the debtor was insolvent within one year of the filing of the petition to an insider who had reasonable cause to believe that the debtor was insolvent, if such transfer enables the creditor to receive more than he would in liquidation. The trustee invokes this section with reference to so much of the mortgage as exceeds the purchase price of the stock, the life insurance ***189** policies, and the cash value of the surrendered life insurance policies.[11]

Since the Court has already held the second mortgage in its entirety and the transfer of the policies to have been fraudulent conveyances, their status as preferences need not be reached. That they were such, however, appears indisputable in this record. As of September 4, 1979, James Martin and Pirrone fit squarely into the Code's definition of insiders (s 101(25)(B)).[12] Pirrone was an officer both before and after September 4, 1979; both he and James Martin were directors, officers, and in control of Vaniman when the transfers were arranged. That they ceased to be such simultaneously with the transfers is of no significance. To give that fact any weight would elevate form over substance. Accordingly, whatever they received in payment of any antecedent indebtedness by way of the value transferred or obligation created within one year prior to July 11, 1980 was a preferential payment, and, therefore, voidable by Vaniman's trustee in bankruptcy.

VI.

THE ALLEGED LOSS AND WASTE OF CORPORATE ASSETS

The trustee's counterclaim alleges that Pirrone and Martin are personally liable to the estate of Vaniman for the monies paid CP&T Sales Co. as a bribe on the ground that such payment constituted a breach of the plaintiffs' fiduciary duty to Vaniman, for which they should be held liable under s 541(a) (1) of the Bankruptcy Code and New York Business Corporation Law s 720(b). The trustee's theory is that s 720(b) creates a cause of action in Vaniman against its directors for "loss or waste of corporate assets" (New York Business Corporation Law s 720),[13] to which Vaniman's trustee succeeded by virtue of 11 U.S.C. s 541(a)(1).[14]

For a number of reasons, this Court will not compel Vaniman's former officers and directors to turn $35,000 over to the trustee in bankruptcy based on events that took place four years before Vaniman filed for relief under the bankruptcy laws and while Vaniman was still a solvent corporation. Although s 720 of New York's Business Corporation Law explicitly authorizes suit by a trustee in bankruptcy, it is well settled that his complaint must show that there are creditors in existence who were such at the time of the alleged wrongful acts or that such acts had as their purpose to defraud present or future creditors. Lummis v. Crosby, 176 App.Div. 315, 162 N.Y.S. 444 (2d Dep't 1916), 181 App.Div. 884, 167 N.Y.S. 1111 (2d Dep't 1917), aff'd, 224 N.Y. 611, 121 N.E. 876 (1918); Garrison v. Pope, 130 Misc. 290, 223 N.Y.S. 737 (Sup.Ct.N.Y.Co.1927); 15 N.Y.Jur.2d Business Relationships s 1065. No such allegations were made or proved.

***190** Neither Vaniman, nor its then creditors, suffered any prejudice from the Colletti deal. Deplorable as commercial bribery may be, it is undisputed that the $35,000 paid

Colletti's company secured a contract for Vaniman from which it derived a profit of $220,000 (383-86). Had Colletti not been paid what he demanded, Vaniman would not have received the business which gave it its profit for 1976.

On the merits, the payments exacted by Colletti could only be deemed to constitute loss or waste of corporate assets if such opprobrium attaches to commercial bribery that, whatever its results, a director or officer who engages in it becomes personally responsible for the amount paid.

No such per se rule exists in New York. Instead, the New York Courts have adopted a case-by-case approach. Instructive in this connection is Hornstein v. Paramount Pictures, Inc., 22 Misc.2d 996, 37 N.Y.S.2d 404 (Sup.Ct.N.Y.Co.1942), aff'd, 266 App.Div. 659, 41 N.Y.S.2d 210 (1st Dep't), app. denied, 266 A.D. 828, 43 N.Y.S.2d 751 (1st Dep't 1943), aff'd, 292 N.Y. 468, 55 N.E.2d 740 (1944). There, the court ruled:

> "(A) payment of corporate funds by way of submission to an illegal exaction is not ipso facto or necessarily a diversion of such funds from legitimate corporate purposes and consequently is not ipso facto or necessarily a breach of the implied trust upon which such funds are held. Whether or not in any particular instance there should be submission and payment or stout resistance thus necessarily must rest in the discretion of the persons constituting the management of the corporation like other business questions in general, and while abuses of that discretion undoubtedly may be reviewed and corrected by the courts, it would require something more than the mere fact of the submission and payment to call forth an exercise of the court's power * * *." 22 Misc.2d at 1008-09, 37 N.Y.S.2d at 417.

Present here is no more than "the mere fact of the submission and payment." Pirrone and Martin agreed on the payments demanded by Colletti only after Colletti made it clear that if Vaniman wanted the contract for which it had bid in good faith, they had no alternative but to pay the amount demanded. Pirrone was not the instigator, but the victim.

The two cases relied upon by the trustee, both brought by stockholders, are not in point. They do not hold that bribery automatically gives rise to an action for waste. In Roth v. Robertson, 64 Misc. 343, 118 N.Y.S. 351 (Sup.Ct. Erie Co. 1909), the purpose of the bribe was to ensure the continued operation of the corporation's business in violation of the Sunday blue laws, an illegal objective. 64 Misc. at 344-45, 118 N.Y.S. at 352-53.[15] In contrast, Vaniman's objective-to secure a business contract-was wholly legal.

Abrams v. Allen, 297 N.Y. 52, 74 N.E.2d 305 (1947), is even more remote. Abrams concerned the sufficiency of a pleading alleging the dismantling and removal of corporate plants and the intentional curtailment of production for the sole purpose of "discourag(ing), intimidat(ing) and punishing" the corporation's employees during a labor dispute." 297 N.Y. at 55, 74 N.E.2d 305.[16]

But the question is not whether in 1976, when the payments were made, Vaniman's minority stockholders had a possible cause of action for waste, but whether in 1980, Vaniman's trustee in bankruptcy does. And it seems clear that the courts of New ***191** York, whose responsibility it is to interpret the law of that State, have determined that absent proof of an existing creditor, who was such at the time of the alleged misfeasance, a trustee in bankruptcy has no cause of action. Lummis v. Crosby, supra.

The soundness of that rule in this case is clear. In 1976, when the payments were made, Vaniman's then creditors were only benefited; its subsequent creditors, who the trustee now represents, were in no way affected. As for Vaniman's stockholders, officers, and directors, and the corporation itself, James Martin and Pirrone were virtually the corporation in 1976, and when they subsequently, sometime prior to September 4, 1979, acquired the few shares they did not already own, there ceased to be anyone who could complain of what they earlier had done with the corporation's funds. 14 N.Y.Jur.2d Business Relationships ss 633, 637; 15 N.Y.Jur.2d Business Relationships s 1062.

That in 1980, Vaniman, for reasons not directly related to the bribe, found itself in the bankruptcy court, should not operate retroactively to create a cause of action where none before existed.

Although commercial bribery is not to be encouraged, it is not the function of the bankruptcy law to provide sanctions which would be unavailable if insolvency had not supervened. Therefore, no judgment will be entered against plaintiffs based on the improper payments exacted by Colletti long prior to bankruptcy.

VII.

EVIDENTIARY QUESTIONS

A. Brady's Financial Statements

The certified public accountant, John F. Brady, who had prepared financial statements for Vaniman for many years preceding its bankruptcy, and up to, and including, August 31, 1979, died about a year before the matter came for trial without his testimony having been perpetuated by means of a deposition. Although counsel for Pirrone and Martin had stipulated that despite Mr. Brady's demise, the financial statements he had prepared for the fiscal years ending December 31, 1977, December 31, 1978, and the eight months terminating August 31, 1979 would be admitted, the stipulation was withdrawn on the eve of the trial, forcing the trustee to attempt to lay a foundation for the admissibility in the absence of the man who had prepared them. Not only was Mr. Brady dead, but counsel for the trustee stated on the record, without contradiction, that Mr. Brady's office no longer existed.

The evidence established that the financial statements for fiscal years 1977 and 1978 had been given by Pirrone to Cote and Jack Martin when he was negotiating with them with respect to the sale of the Vaniman stock (613-15, 122-23; DX-E, P 3.3.1). They had also been given to other potential buyers of Vaniman's assets or business (420-21), and were supplied upon request to the bank with which the company was dealing (78-79). Pirrone had likewise arranged to make the 1979 financial statement available to potential investors. Accordingly, the Court held that these statements could be received as admissions against interest against not only Pirrone, but also against James Martin because of their unity of interest.[17] The record compels the inference that in his dealings with Jack Martin, Pirrone was acting for his partner, James Martin, as well as himself.

In United States v. Feinberg, 140 F.2d 592 (2d Cir.), cert. denied, ***192** 322 U.S. 726, 64 S.Ct. 943, 88 L.Ed. 1562 (1944), Judge Learned Hand held that a corporation's books of account were competent evidence against officers charged with misrepresenting its financial condition:

> "When anyone makes statements as to the financial condition of a corporation, he implies that its books will bear out the truth of what he says, because his hearers will naturally assume that he is speaking of the books, these being ordinarily the only source of information. He is therefore in effect making a statement as to their contents and making them the test of the truth of his utterance." 140 F.2d at 596.

In United States v. China Daily News, Inc., 224 F.2d 670 (2d Cir.), cert. denied, 350 U.S. 885, 76 S.Ct. 138, 100 L.Ed. 780 (1955), the Second Circuit, following this case, held that the books of China Daily News, of which the defendant Moy was Managing Editor and Chairman of the Board, were admissible against him to prove prohibited financial transactions. United States v. Tellier, 255 F.2d 441, 448 (2d Cir.), cert. denied, 358 U.S. 821, 79 S.Ct. 33, 3 L.Ed.2d 62 (1958), elaborated on the principles laid down in Feinberg by holding that to make the books and records of a corporation admissible against those in control of that corporation, all that need be done is establish prima facie their genuineness.

So far as the 1977 and 1978 financial statements are concerned, they would also appear to be admissible under the business records exception to the ban against hearsay.[18] The plaintiffs' testimony that they were prepared annually by Brady in the regular course of Vaniman's business would appear to lay sufficient foundation for their admission.[19] See, e.g., Fernandez v. Chios Shipping Co., Ltd., 542 F.2d 145, 154 (2d Cir. 1976).

Brady prepared these statements in accordance with standard accounting practices.[20] Richard E. Norton, a certified public accountant and a partner at Ernst & Witty, described the 1978 statement as "of reasonably good quality" and would accept it as a "sufficient financial statement" (787-88). The only significant criticisms levelled at these statements by the plaintiffs' expert, Herbert L. Michaels, was that, ideally, Brady should have spent a longer time at the premises of Vaniman in preparing these statements, and should have himself determined the value of the inventory without relying on information supplied by Pirrone (1156-59, 1168-69).

These objections are not sufficient to support the statements' exclusion. The question is not whether the statements are the optimal product of the accounting profession, ***193** but whether they can be deemed sufficiently probative as to warrant their admissibility. In view of Brady's long association with Vaniman, the statements' preparation need not necessarily have taken any significant time. As to the plaintiffs' second objection, they are not in a position to object to the utilization of figures supplied by themselves. To the extent that Brady departed from exemplary accounting procedures, these departures probably benefited Martin and

Pirrone in their attempts to sell the company and are probably working to their advantage in this case.

Further, all the financial statements, including the 1979 statement, are admissible against both Martin and Pirrone under the omnibus exception to the hearsay rule.[21] Upon reflection, the Court has concluded that all the requirements of the exception are met here. The statements are internally consistent and correspond with Vaniman's books and records; they were not prepared in anticipation of litigation, but for business purposes, and no "reasonable efforts" will yield more probative evidence on such historical facts as the inventory on hand at Vaniman on September 4, 1979. To exclude them would frustrate, rather than serve, the interests of justice.

Before leaving the statements prepared by Brady, it merits noting that the efforts of James Martin to discredit the accuracy of the 1978 statement (1198-1203) were wholly ineffective. Vaniman's general ledger (DX-L) supports both the consultant's and accountant's fees shown on Exhibit C; Martin's inability to recall any legal services in 1978 conveniently blocks out the Grand Jury investigation that year into Vaniman's payments to Colletti for its contract with the Ford Export Division.

B. The Fair Market Value of Vaniman's Realty on September 4, 1979

A number of figures went into evidence bearing on the value of the Vaniman real estate in September, 1979. Based on the totality of that evidence, the Court has concluded that the property at that time did not have a fair market value in excess of $380,000.

In the view of the Court, the sale at auction of the property for $535,000 in February, 1981 under the auspices of the bankruptcy court after Vaniman was adjudicated is not a true indication of its value seventeen months earlier. Until recently, we have been living in inflationary times with steadily-appreciating real estate values.

On the other hand, the Court found unacceptable the value of $273,000 which a real estate expert put on the premises as of September 4, 1979 (1268-86; DX-W). That the property had a higher value is shown by the fact that a year earlier, on November 13, 1978, Vaniman had been offered $375,000 by its neighbor for whose use the property was ultimately purchased at the bankruptcy sale (PX-4). In determining market value, the Court has attached no weight to the letter of July 16, 1979 proposing a contract for $460,000 (PX-5). The offer was made contingent upon the availability of financing from the Job Development Authority, a contingency which might never be realized.

Finally, the wholehearted adoption by the plaintiffs of the value of $360,000 at the ***194** hearing on October 15, 1980 on the complaint of Roslyn Savings Bank for relief from stay limits their ability now to claim a higher market value. See 1B Moore's Federal Practice P 0.405(8), at 765 (2d ed. 1982); see also Scarano v. Central Railroad Co., 203 F.2d 510, 513 (3d Cir. 1953); Beck, "Estoppel Against Inconsistent Positions in Judicial Proceedings," 9 Brooklyn L.Rev. 245 (1940). After Roslyn's expert had testified that the fair market value of Vaniman's real estate was $360,000, the following colloquy (made part of the record herein at 425-27) took place:

> "MR. FELDMAN: Your Honor, before you conclude * * *. I would, at least, at this time move and request that this Court deem the testimony as to valuation, that was taken in this court as to this particular hearing, be applicable in my proceeding on behalf of the subordinate mortgagees against the debtor. Because to bring in a witness again to testify as to valuation, I think would be an unnecessary and undue hardship, since we already have that testimony. The question as to the raised validity of the mortgage, is something that can be tried, of course, but as to valuation, can we have that testimony deemed applicable in the second proceeding, your Honor?
>
> "THE COURT: All right, the Court will consider the testimony as to valuation given in the case of Roslyn Savings Bank against the debtor as part of the record of your action against Vaniman, Pirrone and Martin against Vaniman International.
>
> "MR. FELDMAN: Thank you, your Honor." (Emphasis supplied) (135-36)

The plaintiffs herein, having urged when it was to their advantage to do so that Vaniman's realty was worth no more than $360,000, are now judicially estopped from insisting on a higher value.

C. James Martin's Denial of Knowledge of the Ford Bribe

Although James Martin has denied any knowledge that the contract with the Ford Export Division was obtained only after Colletti had been promised a kickback (1204-05, 1221-22, 1232), the Court does not believe that Pirrone could or would have kept such an important fact a secret from his partner. The Court, therefore, credits Pirrone's original version that James Martin knew and authorized the payments to Colletti (231-32, 1217-18), although, like Pirrone, he was unhappy about their necessity.

VIII.

ATTORNEYS' FEES

Under s 276-a of New York's Debtor and Creditor Law, proof that a conveyance has been made with actual intent to hinder, delay, and defraud creditors entitles the prevailing party to attorney's fees. Bartle v. Markson, 299 F.Supp. 958, 966-67 (N.D.N.Y.1969), aff'd, 423 F.2d 637 (2d Cir. 1970). While no similar authority appears in the Bankruptcy Code, the bankruptcy court, as a court of equity, has the reserved power to award attorneys' fees in exceptional situations, as where gross misconduct is involved, as here. See In re Miller, 14 B.R. 443 (Bkrtcy.E.D.N.Y.1981); In re Silverman, 13 B.R. 270, 24 C.B.C. 471 (Bkrtcy.S.D.N.Y.1981); see also Alyeska Pipeline Service Co. v. Wilderness Society, 421 U.S. 240, 95 S.Ct. 1612, 44 L.Ed.2d 141 (1975). In the view of this Court, attorneys' fees are necessary in this case both to make the defrauded creditors whole, and to deter conduct of the character present here. Undoing the fraudulent conveyances is not enough.

The creation of a second mortgage has had serious implications for Vaniman, and has substantially diminished the assets available to creditors by the costs to the estate which it has created. Any possibility of rehabilitating Vaniman under Chapter 11 required that it be left in possession of its real estate, which James Martin and Pirrone opposed when they initiated the present proceeding seeking relief from stay so they could enforce the mortgage which this Court has now found was created in ***195** fraud of creditors. It is true that Roslyn Savings Bank, which held a first mortgage on Vaniman's realty, was seeking similar relief, but the fair market value of the Vaniman real estate was so far in excess of Roslyn's claim that the debtor, if it faced Roslyn alone, and if its financial situation had not been so grave, might well have been permitted to stay in possession of its real estate had the outstanding second mortgage not reduced its equity to zero. When Vaniman's Chapter 11 petition was converted to Chapter 7, James Martin and Pirrone continued to press to remove Vaniman's real estate from the bankruptcy court and strenuously opposed its sale, predicating their opposition on the mortgage they had created on September 4, 1979, forcing the trustee into extended litigation to establish his right to do no more than liquidate Vaniman's assets.

This proceeding itself has been time consuming, involving discovery and pretrial conferences, as well as a protracted trial. None of this would have been necessary but for the wrongful creation of a purported security interest in Vaniman's real estate. Simply avoiding the fraudulent conveyances, declaring the mortgage invalid, and requiring James Martin and Pirrone to restore the life insurance policies to Vaniman will not act as a deterrent, since anyone similarly tempted will calculate correctly that they have nothing to lose by similar misconduct if the worst that can happen is that they be required to restore what was improperly taken. Furthermore, the creditors of Vaniman should not be penalized for the wrongdoing of James Martin and Pirrone. Martin and Pirrone, not Vaniman's creditors, should bear the cost of the extensive litigation which they have forced on the trustee in bankruptcy.

Accordingly, an appropriate application should be submitted to this court to determine the amount of attorneys' fees to be awarded.

IX.

EQUITABLE SUBORDINATION

In distributing the estate of an insolvent debtor, the bankruptcy court has the power to subordinate the claims of certain creditors on the basis of equitable principles. Pepper v. Litton, 308 U.S. 295, 60 S.Ct. 238, 84 L.Ed. 281 (1939); Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215, 61 S.Ct. 904, 85 L.Ed. 1293 (1941); In re Mobile Steel Co., 563 F.2d 692 (5th Cir. 1977); 11 U.S.C. s 510(c). The plaintiffs oppose any consideration of this principle as premature in that no claims have as yet been filed by them in this proceeding. They also point out that the doctrine is not relied on in the trustee's counterclaims.

Because of the position taken by the plaintiffs, the Court is abstaining from deciding at this time whether, and to what extent, claims yet to be filed by either James Martin or Pirrone should be subordinated to those of the creditors whom they sought to defraud. Yet, it should be self-evident that the doctrine of collateral estoppel will apply to any proceedings which may raise that issue.

X.

JURISDICTION

This Court's delay in deciding this case, due to the unprecedented caseload with which the bankruptcy judges have been struggling, has resulted in this opinion issuing after the Supreme Court's critical decision in Northern Pipeline Construction Co. v. Marathon Pipeline Co., 458 U.S. 50, 102 S.Ct. 2858, 72 L.Ed.2d —— (1982). However, the Supreme Court has expressly denied a retroactive application of that decision, and has stayed its judgment until October 4, 1982. Moreover, apart from the bribery issue, the other matters decided are within the traditional competence of the bankruptcy court relating, as they do, to issues of preference and fraudulent conveyances. As the majority in Northern Pipeline pointed out: "The restructuring of debtor-creditor relations, which is at the core of the Federal bankruptcy power, must be distinguished from the adjudication of state-created private rights * * *." Id. at ——, 102 S.Ct. at 2871-72. Five members ***196** of the Supreme Court appear to agree that the bankruptcy court may continue constitutionally to restructure debtor-creditor relations, just as it did prior to 1978. Thus, there is no constitutional impediment to decisions of the issues in this case, even apart from the fact that the Supreme Court has stayed its judgment and is not applying it retroactively. As to the key issue-the validity of the second mortgage held by Martin and Pirrone-the bankruptcy court's possession of the proceeds of the sale of the Vaniman realty gives it clear in rem jurisdiction to decide the validity of that lien.

CONCLUSIONS OF LAW

1. The transfers made, and obligations incurred by Vaniman pursuant to the terms of the Purchase Agreement dated September 4, 1979 (hereinafter "Purchase Agreement"), were made with actual intent to hinder, delay, and defraud existing and future creditors. They constitute fraudulent conveyances under s 548(a) of the Bankruptcy Code, and s 276 of New York's Debtor and Creditor Law. Vaniman's trustee in bankruptcy may avoid such transfers and obligations under s 548(a)(1) of the Bankruptcy Code, and because, on September 4, 1979, there were actual existing creditors of Vaniman who could have avoided them, the trustee may also avoid them by virtue of s 544 of the Bankruptcy Code.

2. Vaniman did not receive from Joseph T. Pirrone and James A. Martin reasonably equivalent value for the transfers made and the obligations incurred pursuant to the terms of the Purchase Agreement. Likewise, Vaniman did not receive fair consideration within the meaning of s 272 of the New York Debtor and Creditor Law. As a result of such transfers and of the obligations which Vaniman incurred pursuant to the Purchase Agreement it (a) became insolvent, (b) was left with an unreasonably small capital for the business in which it was engaged, and (c) intended to incur, and it was believed that it would incur, debts beyond its ability to pay as such debts matured.

3. The transfers made and obligations incurred pursuant to the Purchase Agreement are therefore voidable by the trustee pursuant to s 548(a)(2) of the Bankruptcy Code.

4. The transfers made and obligations incurred pursuant to the Purchase Agreement constitute fraudulent conveyances within the meaning of ss 273, 274, and 275 of New York's Debtor and Creditor Law. On September 4, 1979, there were actual existing creditors of the debtor who could have avoided such transfers and obligation under ss 273, 274, and 275 of New York's Debtor and Creditor Law, and, therefore, defendant, as trustee, may avoid such transfers pursuant to s 544 of the Bankruptcy Code.

5. On September 4, 1979, Joseph T. Pirrone and James A. Martin were insiders within the meaning of s 101(25)(B) of the Bankruptcy Code, and had reasonable cause to believe the debtor was insolvent on such date. By virtue of the transfer to them of certain insurance policies, the cash surrender value of other policies, and $33,857 in a second mortgage they received, on account of an antecedent indebtedness, more than they would have received under the provisions of the Bankruptcy Code. Accordingly, these transfers all constitute preferences which Vaniman's bankruptcy trustee may avoid under s 547 of the Bankruptcy Code.

6. The bankruptcy trustee may not recover under s 541(a)(1) of the Bankruptcy Code and New York's Business Corporation Law s 720(b) for the plaintiffs' breach of their fiduciary duty to the debtor corporation by reason of the payments made indirectly to an employee of the Ford Motor Company-Export Division in 1976.

7. The obligations incurred and the transfers and payments made by Vaniman to the plaintiffs pursuant to the Purchase Agreement are all invalid and voided.

8. The lien claimed by Joseph T. Pirrone and James Martin on the proceeds of the sale of Vaniman's real property is of no force and effect and shall be deemed discharged as of record.

***197** 9. The trustee is entitled to recover for the benefit of the estate from Joseph T. Pirrone and James A. Martin New York Life Insurance Policy No. 27700543 on the life of Joseph T. Pirrone, and Travellers Life Insurance Policy No. 99045NW202 on the life of James A. Martin, and is entitled to recover from Joseph T. Pirrone the $10,652.79 cash value of the policies surrendered by the debtor.

10. The trustee is entitled to recover reasonable attorneys' fees from James T. Pirrone and James A. Martin.

Pursuant to Bankruptcy Rule 754(b), the Court is awarding costs to the trustee.

The foregoing constitutes the Court's Findings of Fact and Conclusions of Law.

Submit judgment.

All Citations

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Footnotes

1 All numbers in parentheses not otherwise identified are to the transcript of the trial.

2 On July 16, 1979, Kreindler wrote Pirrone requesting preparation of a contract to sell the property to the same principals for “$460,000, subject to Job Development Authority financing” (PX-5).

3 This loss would have been closer to $30,000, except for the inclusion in Vaniman's income of rental payments and $15,000 given Vaniman in connection with the sale by James Martin and Pirrone of their Vaniman stock to Jack Martin (DX-D, at schedule 3).

4 Pirrone and Martin called as a witness a former Vaniman customer, Peter Masiakou, to establish that Vaniman's financial statements, in particular, Schedule 6-1 to Exhibit D, did not fully reflect all the equipment on hand on September 4, 1979, and that the fair market value for Vaniman's equipment as of that date was around $95,000 or $96,000 (1101). What Masiakou did was to examine schedule 6-1 to DX-D, then add to the figure shown there as the cost of Vaniman's equipment whatever he could recall as being on the premises and not specifically described in that exhibit (1085-1105; Court Ex. One). Even so, the highest figure he was able to support was $71,291 (Court Ex. One). Moreover, the internal evidence provided by the various financial statements negates Masiakou's assumption that the financial statements did not fully reflect the value of miscellaneous tools or of the De Vilbis spray booth (compare DX-C, schedule 6-1 (which is identical, except for the differences in depreciation, with DX-D, schedule 6-1) with DX-A, schedule 1, p. 3). By adding figures derived from two sources, Vaniman's financial statements and his own recollection, Masiakou necessarily duplicated values. For other reasons as well, his testimony lacks probative value.

5 The life insurance values on the lives of Vaniman's officers which had entered into the figures reflecting assets and liabilities in Vaniman's previous financial statements are lacking from the statement prepared for the period terminating on August 31, 1979, probably because of the transfer of these policies to James Martin and Pirrone pursuant to the Purchase Agreement of September 4, 1979.

6 Among other reasons for viewing Vaniman's 1979 balance sheet as overstating assets is that the balance sheet credits Vaniman with cash of $8,442.20, although this was simply a temporary circumstance (505).

7 Jack Martin testified that when he signed the agreement in Pirrone's office in the presence of Pirrone and James Martin, “Mrs. Janaskie and her people, Castellano and Pepe, were really turning the place upside down, and we had to do something, we, the three of us, had to do something to protect our interests down there. I was frustrated. I didn't know what to do. I told (Pirrone) I didn't know what to do. (Pirrone and James Martin) had suggested the only thing they can do is

basically I am out and at any time they can stop me from coming on to the premises, but if I sign the employment contracts, that would allow Mr. Pirrone to stay in the office and keep an eye on the company and watch out for our interests" (530).

7a Roslyn Savings Bank v. Vaniman International, Inc. (Vaniman International, Inc.), Bankr.No. 180-03984-21; Adversary No. 180-0772-21 (B.C.E.D.N.Y.), Hearing, Oct. 15, 1980, Tr. at 50-58.

7b Id. at 135-36.

8 Section 548(a) provides:

"The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor-

"(1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer occurred or such obligation was incurred, indebted; or

"(2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

"(B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

"(ii) was engaged in business, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or

"(iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured."

9 Hereinafter, all citations in this section to Collier on Bankruptcy will be to the 15th edition (1982) of that treatise.

10 When asked to pinpoint the time when he became familiar with the business in which Vaniman was engaged, the installation of truck bodies, Martin replied: "I couldn't put a time when I became qualified. I may not be qualified now." (852.) His responses confirmed this self-assessment. He was unable to estimate the profits to Vaniman from the Ford order, one of the three on hand when he bought Vaniman's stock (852), nor could he state what was charged Lilco per vehicle on another order, or the amount of labor required, beyond saying: "(T)he labor was unbelievable * * * I would say (it took) hundreds (of hours)," explaining: "Mr. Kral is not here, available to me, but he was taking care of that whole order, himself" (850-51). When a question arose during his presidency with respect to an order from GM that was large "by Vaniman's standards," he was completely lost because "Mr. Pirrone was in Florida. He had all the papers with him of the prices on it." (666.)

11 The trustee has apparently elected not to attempt to recover as preferences the post-September 4, 1979 payments made Pirrone.

12 Section 101(25)(B) defines an "insider" as: "(B) if the debtor is a corporation-(i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor.

13 Section 720 of the New York Business Corporation Law provides in pertinent part:

"(a) An action may be brought against one or more directors or officers of a corporation to procure a judgment for the following relief:

"(1) To compel the defendant to account for his official conduct in the following cases:

"(A) The neglect of, or failure to perform, or other violation of his duties in the management and disposition of corporate assets committed to his charge.

"(B) The acquisition by himself, transfer to others, loss or waste of corporate assets due to any neglect of, or failure to perform, or other violation of his duties.

"(2) To set aside an unlawful conveyance, assignment or transfer of corporate assets, where the transferee knew of its unlawfulness.

"(b) An action may be brought for the relief provided in this section * * * by a * * * trustee in bankruptcy * * *."

14 Section 541(a)(1) of the Bankruptcy Code provides that the bankruptcy estate shall consist of "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. s 541(a)(1).

15 The Roth decision has been characterized as "(a) relatively pure-and rare-expression of the interventionist style" of judicial review of corporate decision making. See Stone, "The Place of Enterprise Liability in the Control of Corporate Conduct," 90 Yale L.J. 1, 60 n.230 (1980).

16 In re Leasing Consultants, Inc., 592 F.2d 103 (2d Cir. 1979), is also not apposite. In that case, it was not the bribery per se that gave rise to a right of recovery by the bankruptcy trustee against the recipient of a bribe, by extension of s 720 of New York's Business Corporation Law, but that the payments were made in furtherance of a conspiracy to violate 18 U.S.C. s 203, a criminal statute relating to conflict of interest.

17 The common law rule respecting admissions is codified and liberalized by Rule 801(d) of the Federal Rules of Evidence, which provides:

"A statement is not hearsay if- * * *

"(2) * * * The statement is offered against a party and is (A) his own statement, in either his individual or a representative capacity or (B) a statement of which he has manifested his adoption or belief in its truth, or (C) a statement by a person authorized by him to make a statement concerning the subject, or (D) a statement by his agent or servant concerning a matter within the scope of his agency or employment, made during the existence of the relationship, or (E) a statement by a co-conspirator of a party during the course and in furtherance of the conspiracy."

18 Rule 803 of the Federal Rules of Evidence provides, insofar as relevant:

"The following are not excluded by the hearsay rule, even though the declarant is available as a witness: * * *

"(6) Records of Regularly Conducted Activity. A memorandum, report, record * * * in any form, of acts, events, conditions * * * made at or near the time by, or from information transmitted by, a person with knowledge, if kept in the course of a regularly conducted business activity, and if it was the regular practice of that business activity to make the memorandum, report, record * * * all as shown by the testimony of the custodian or other qualified witness * * *."

19 "Q (by Mr. Salomon) Do you recall testifying at a June 18th deposition?

"A (by James Martin) Yes.

"Q * * * Do you recall being asked these questions and giving these answers, Mr. Martin?

"QUESTION: 'But as to Exhibits A and C, did the company, as a continuing matter, request these exhibits to be furnished, in the ordinary course of its operations?'

"ANSWER: 'Well, that was part of our contract with Mr. Brady, that he provide us with annual financial statements.'

"QUESTION: 'These were received in the regular course of business, is that fair to say?'

"ANSWER: 'Yes.'

"Were you asked those questions and did you give those answers, sir?

"A Yes." (864, 869)

20 Pirrone's own testimony establishes that Brady visited Vaniman "about once a year" (377) to spot-check the inventory and examine the bookkeeping entries (85-86). Further, Pirrone acknowledged that he had "complete faith in (the accuracy of) Mr. Brady's financial statements * * *," at least until February, 1981 (72, 97; see also 495).

21 Rule 804(b) of the Federal Rules of Evidence provides in pertinent part:

"The following are not excluded by the hearsay rule if the declarant is unavailable as a witness: * * *

"(5) Other Exceptions. A statement not specifically covered by any of the foregoing exceptions but having equivalent circumstantial guarantees of trustworthiness, if the court determines that (A) the statement is offered as evidence of a material fact; (B) the statement is more probative on the point for which it is offered than any other evidence which the proponent can procure through reasonable efforts; and (C) the general purposes of these rules and the interests of justice will best be served by admission of the statement into evidence. However, a statement may not be admitted under this exception unless the proponent of it makes known to the adverse party sufficiently in advance of the trial or hearing to provide the adverse party with a fair opportunity to prepare to meet it, his intention to offer the statement and the particulars of it, including the name and address of the declarant."

End of Document

TAB 5

Jackson v. Mishkin (In re Adler, Coleman Clearing Corp.)

United States District Court for the Southern District of New York

June 11, 2001, Decided ; June 11, 2001, Filed

00 CIV. 4216 (VM), 00 CIV. 4217 (VM)

Reporter
263 B.R. 406 *; 2001 U.S. Dist. LEXIS 7552 **; 44 U.C.C. Rep. Serv. 2d (Callaghan) 1125

In re ADLER, COLEMAN CLEARING CORP., Debtor. DAVID A. JACKSON, DONALD D. DOTY, JOHN L. NAPPI, THOMAS CROUCH, DAVID LASKEY, A.J. MARKS, JR., CHARLOTTE MARKS, ALFRED MARKS, ALFRED J. MARKS, JR., Appellants, -against- EDWIN B. MISHKIN, AS TRUSTEE OF ADLER, COLEMAN CLEARING CORP., Appellee.

Disposition: [**1] Judgment of bankruptcy court in this matter affirmed.

Counsel: For DAVID A. JACKSON, DONALD D. DOTY, JOHN L. NAPPI, THOMAS CROUCH, DAVID LASKEY, ALFRED J. MARKS, JR., appellants (00-CV-4216): Jed Horwitt, Stephen M. Kindseth, Zeisler & Zeisler, Bridgeport, CT.

For EDWIN B. MISHKIN, appellee (00-CV-4216): Mitchell A. Lowenthal, Cleary, Gottlieb, Steen & Hamilton.

For WILLIAM G. GIARUSSO, ESTERE KUNIS, appellants (00-CV-4217): Jed Horwitt, Stephen M. Kindseth, Zeisler & Zeisler, Bridgeport, CT.

For EDWIN B. MISHKIN, appellee (00-CV-4217): Mitchell A. Lowenthal, Thomas J. Moloney, Cleary, Gottlieb, Steen & Hamilton, New York, NY.

Judges: VICTOR MARRERO, UNITED STATES DISTRICT JUDGE.

Opinion by: VICTOR MARRERO

Opinion

[*414] ***DECISION AND AMENDED ORDER***

VICTOR MARRERO, UNITED STATES DISTRICT JUDGE.

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[*416] ***INTRODUCTION***

Innocence has many faces, and perhaps embodies as many notions of the word's meaning as the number of self-proclaimed innocents from time immemorial who have invoked the blessings of its absolution. Central to the appeal before the Court is a consideration of innocence: the limits of the concept, how far it validly expands and whose conduct it embraces -- beyond the hyperbole [**4] to which the term often gives rise. In their opening argument, Appellants declare: "For the first time in American Jurisprudence, a court has held innocent customers liable for the frauds perpetrated by a market-maker simply because it was also their executing broker." Appellants' Brief, dated July 14, 2000 ("Appellants' Brief"), at 5.

In the same vein, repeatedly throughout their lengthy briefs here, as well as before the bankruptcy court, Appellants pronounce their blamelessness. Vigorously and indignantly, they portray themselves as "innocent public investors" whose only role in the events here at issue was their mistaken choice of unethical or dishonest brokers with whom they dealt at arms length and in good faith and for whose frauds and other misdeeds Appellants contend they should not be held responsible. Appellants' Reply Brief, dated November 17, 2000 ("Appellants' Reply"), at 1-2. By their account, Appellants are faultless victims of the bankruptcy Trustee's zealous pursuit of the proceeds of certain allegedly tainted securities transactions that are the subject of this appeal. Appellants seek to retain the benefits of bargains they struck with their corrupt brokers in connection [**5] with those trades, for this purpose invoking the shelter and safeguards of the Securities Investors Protection Act of 1970 ("SIPA"), 15 U.S.C. §§ 78 aaa-lll. *See* Appellants' Reply at 1, 3.

In this context, Appellants' remonstrances put in play here the definition and proper bounds of the notion of innocence. In its ordinary sense, innocence denotes an absence of a particular state of mind -- for example, a lack of culpable knowledge or intent -- which in turn generally derives from an absence of causal involvement by a person in the harms or undue gains associated with a given wrongful act. This lack of knowing participation serves as the innocent's defensive shield, justifying his claim to be screened or absolved of responsibility for the consequences of the underlying deed.

As unfolds below, however, and as is frequently the case even in connection with the most passionate incantations of the term, there is often more to innocence than meets the eye. Profoundly held convictions of one's own clean hands at times play tricks of the mind, blurring objectivity, concealing from comprehension or view the person's actual role in unavowed causes and effects, and [**6] impeding discernment of shades of involvement and responsibility not immediately apparent to the naked or subjective eye. And, beyond a person's own actions, whether the given conduct is individually or externally controlled, circumstances may prevail under which the law, in disregard of the innocent's protestations, and indeed at times even conceding whatever validity due them, may still impose liability, not on account of anything the person may have done or omitted to do, but, for reasons of equity or policy, by imputing to the apparent bystander the misconduct of a sufficiently related wrongdoer. By these means, the law recognizes that even innocent association with scoundrels has its limitations, and its costs. Occasions arise when the villain chooses to exploit the relationship and betray the trust, and then the supposed "innocent" may be obligated [*417] to pay a price. The operation of these principles drives much of what is at issue on this appeal.

I. *FACTS* [1]

[**7] A. *THE PARTIES AND THEIR TRANSACTIONS*

Hanover Sterling & Company ("Hanover") was an introducing broker-dealer, located principally in New York City. Its main business was underwriting certain initial public offerings ("IPO's") of securities. Hanover would act as the market-maker for these securities (the "House Stocks"). As such, it held itself out as ready to buy House Stocks (for which it set a "bid" price) and sell House Stocks (for which it set an "ask" price). In particular, whenever a Hanover customer bought or sold House Stocks, Hanover acted as a "middle man" in the purchase or sale of those securities. Hanover was registered with the Securities Exchange Commission ("SEC") and was a member of the National Association of Securities Dealers ("NASD") and the Securities Investors Protection Corporation ("SIPC").

Adler, Coleman Clearing Corporation ("Adler"), the subject of the bankruptcy court liquidation proceeding from which this appeal arises, was a securities clearing house broker-dealer which "cleared" or "settled" executed trades on behalf of other brokerage firms. Hanover was among 42 introducing firms that Adler serviced. Adler was also registered with the SEC, [**8] and was a member of SIPC, NASD, as well as the New York Stock Exchange ("NYSE") and the National Securities Clearing Corporation ("NSCC").

Pursuant to an agreement with Hanover dated August 22, 1994 (the "Clearing Agreement"), Adler undertook to clear trades for Hanover. This contract obligated Adler to: (a) clear and settle trades at Hanover's instructions; (b) prepare and mail trade confirmations to Hanover's customers; (c) settle contracts and securities transactions between Hanover and other broker-dealers (the "Street" transactions), and between Hanover and the customers it introduced to Adler; (d) perform cashiering functions for Hanover's customers' accounts; and (e) maintain copies of the documentation relating to the accounts of Hanover's customers. In clearing and settling trades, it was Adler's responsibility to ensure that securities and cash were transferred to and from the appropriate Hanover and customer accounts and that this information was properly recorded and reported to Hanover and the customers. Consequently, while Hanover had primary direct dealings with its customers, it was Adler that held the customers' cash and securities.

In addition to servicing customer [**9] accounts, Adler cleared and settled trades for Hanover's own proprietary accounts. The securities from both Hanover's proprietary and customer accounts were held at Adler's Depositary Trust Company account, while cash for these accounts was held in other Adler bank accounts. When Hanover executed trades on behalf of its customers with the Street, Adler cleared the transactions through the NSCC, which [*418] would match buy and sell orders between Adler and the other brokerage houses involved.

When Adler instituted liquidation proceedings under the circumstances described below, over 15,000 customers filed claims, several hundred of which were denied for various reasons by the court appointed trustee, Edwin B. Mishkin (the "Trustee"). Among those denied are claims of several hundred customers that arose from transactions which occurred during the period February 17 through February 24, 1995, Hanover's last five days

[1] The facts recited here are taken from the factual recitation of the bankruptcy court set forth in the decision (herein the "Decision") which is the subject of this appeal. The Decision is reported in *Mishkin v. Ensminger (In re Adler, Coleman Clearing Corp.)*, 247 B.R. 51 (Bankr. S.D.N.Y. 1999), citations to the text and holdings of which are referred to herein as the "*Decision*". The definitions and terminology used in this Opinion are adopted from those employed by the bankruptcy court in the Decision. Except where quoted or as otherwise specifically indicated, the factual summary detailed below derives from the facts section reported at pages 65-72 of the *Decision*.

in business (the "Final Week"). The eight [2] Appellants in this appeal were among approximately 133 claimants (the "Claimants") who took the Trustee's denials of their claims to trial. [3] [**11] Their claims for cash and securities arise out of sales of House Stocks (the "Challenged [**10] Sales") and related purchases of certain Blue Chip [4] securities (the "Challenged Blue Chip Buys") these customers ordered Hanover to execute during the Final Week [5] (collectively the "Challenged Trades").

[**12] In connection with certain of these transactions, the proceeds of the Challenged Sales were to be applied to pay for Appellants' Blue Chip Buys. With regard to transactions that occurred up to February 23, 1995 Adler sent trade confirmations to the customers effectuating the transactions. No such confirmations were sent with respect to the Challenged Trades that occurred on February 24 because, as described below, Adler retrieved the confirmations before they were transmitted to the customers.

B. *THE ILLEGAL SHORT SELLING*

Beginning around January 20, 1995, a group of broker-dealers (the "Short Sellers") engaged in a pattern of short selling House Stocks in order to depress the market price of the securities. [6] While short [*419] selling, by definition, involves trading stock the seller does not own, the Short Sellers here had not arranged to borrow the House Stocks they purportedly sold and the securities were not publicly available. These sales were illegal because they violated NASD rules, as well as federal law, including § 10(b) of the 1934 Securities and Exchange Act, 15 U.S.C. § 78j(b). This illegal short selling took place between January 20, 1995 and [**13] March 20, 1995 (the "Short Selling Period"). In addition to this illegal activity, the Short Sellers depressed the price of the House Stocks by planting negative information about Hanover and some of the House Stocks with Dan Dorfman, a financial reporter for television station CNBC. Mr. Dorfman transmitted a negative assessment of the stocks in his January 20, 1995 broadcast and reported that Hanover was under investigation by the SEC. Moreover, the Short Sellers spread rumors that Hanover was going to fail by reason of the short-selling scheme.

[**14] C. *THE NET CAPITAL COMPLIANCE RULE AND HANOVER'S RESPONSE TO ILLEGAL SHORT SELLING*

To understand the effect of the illegal short selling on

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[2] As filed with this Court, the appeal named nine Appellants. They were David A. Jackson; Rabbi Mark Kunis; Alfred J. Marks, Jr.; Thomas C. Crouch; Donald T. Doty; William Giarusso; David P. Laskey; Michael Polselli; and John T. Nappi. *See* Appellants' Brief at 26-33. At the oral argument the Court conducted on the matter, Appellants counsel informed the Court that Mr. Polselli had reach a settlement with the Trustee and was no longer a party to this appeal. *See* Transcript of Oral Argument on April 10, 2001 at 2.

[3] The remaining Claimants did not pursue their claims on this appeal. *See* Trustee's and SIPC's Opposition Brief, dated September 29, 2000 ("Trustee's Brief"), at 2-3. Throughout this Opinion the Court refers to Claimants in a manner consistent with the bankruptcy court's references insofar as the Decision pertains to all Claimants. Where the context requires reference to Appellants separately from Claimants the Opinion will so differentiate.

[4] Securities other than House Stocks.

[5] One point of contention between the parties to this appeal is whether Appellants were "favored customers." *See* Appellant's Brief at 25-26; Trustee's Brief at 13. The issue might be semantic in part. The Trustee defines "favored customer" as a customer in whose account Challenged Trades were booked, while Appellants' definition rests on whether a customer was an insider in Hanover's business or a relative of insiders. Trustee's Brief at xiv; Appellants' Brief at 26. The bankruptcy court did not treat this question as material to a resolution of the issues before it, stating that whether or not a Claimant was a "favored customer" did not determine liability for Hanover's fraud. *See Decision*, 247 B.R. at 134. Rather, the court regarded that determination as resting on whether the Claimant was seeking to enforce Challenged Trades. *See id.* The court also noted, as further discussed below, that whether or not a customer was particularly favored or a beneficiary of Hanover's actions did not matter in connection with the Trustee's theory of constructive fraud. *See id.*

[6] Short selling involves the sale of stock that the seller actually does not own, but has arranged with a broker to borrow. The seller pays a fee while it borrows the stock and eventually is called upon to "cover" the short sale by returning the equivalent amount of stock to the broker. *See United States v. Russo*, 74 F.3d 1383, 1388 (2d Cir. 1996). The seller hopes that the price of the stock drops between the date of sale and the date he must pay for the borrowed stock, in which case his profit is the difference between the two amounts. At the time of the events at issue here, short sales were subject to regulations requiring the seller to advance margin equal to 50% of the value of the securities sold short. *See Russo*, 74 F.3d at 1388.

Hanover, as well as Hanover's response to these activities, a description of the SEC's net capital rule is necessary. Both Adler and Hanover were required to comply with the SEC's net capital rule which obligates broker-dealers to maintain a certain level of net capital intended to protect investors. Net capital is calculated by subtracting from a broker-dealer's total capital "the aggregate of certain non-allowable assets, operational charges and 'haircuts'." *Decision*, 247 B.R. at 68. "Haircuts" represent charges against net capital to assess the real market value in a broker-dealer's proprietary accounts and to account for the risk level of the broker and the concentration of stock in its proprietary account for which it is the market-maker. *See id.* If a market-maker retains too much of its own stock among its assets, its net capital may be devalued because the dealer could not easily liquidate its position without lowering the price of the stock. The amount of liquid capital that the broker-dealer needs to maintain [**15] depends on the type of business it conducts.

Every month, Adler and Hanover were required to report their financial information in a Financial and Operational Combined Uniform Single Report (the "FOCUS Report") which contained a monthly calculation of net capital. Net capital must be calculated on a monthly basis, and more frequently if a broker-dealer approaches non-compliance. If a company reaches non-compliance, it must file a report notifying the appropriate self - regulatory organization: NASD for Hanover and NYSE for Adler.

As of December 31, 1994, prior to the Short Selling Period, Hanover's net capital was reported at $ 3,478,665.00 over its $ 297,798.00 net capital requirement. However, this surplus plummeted to $ 162,000.00 by the end of January 1995. This steep decline was a product of the illegal activities of the Short Sellers, who [*420] caused a depression in the price of the House Stocks, as well as a rise in the volume of House Stocks in Hanover's proprietary accounts, and prompted corresponding increases in Hanover "haircuts".

Hanover was compelled to respond to the downward pressures on House Stock prices for two important reasons: (1) Hanover's customers, including [**16] Hanover officers, brokers, and relatives, owned large amounts of House Stocks and (2) Hanover's net capital was supported by large quantities of House Stocks in its own proprietary accounts. In response to the illegal short selling, Hanover could have either lowered the price of the House Stocks or supported those prices by purchasing the House Stocks the Short Sellers were offering at the prices Hanover posted. Hanover, as market-maker for the House Stocks, was empowered to lower their prices, thereby discouraging the Short Sellers who could profit only by buying high and selling low. This strategy, however, would have resulted in losses to Hanover's customers and to Hanover itself through its proprietary accounts, thereby further threatening Hanover's net capital.

Hanover chose to respond by purchasing the Short Seller's House Stocks at inflated prices. However, Hanover could not sustain these purchases indefinitely because a higher concentration of House Stocks in its own accounts would mean increased haircuts, which in turn would mean lower net capital. Thus, Hanover felt pressured to find the means to sell House Stocks to customers or to the Street at Hanover's quoted prices.

[**17] By February 13, 1995, Hanover could no longer find customers to purchase the House Stocks in its proprietary accounts. Nonetheless, it continued buying such securities at the inflated prices it quoted. To avoid the negative effect of these acquisitions on its net capital, Hanover had to offset these purchases with corresponding sales. It chose to do so by recording fictitious "buys" of House Stocks in customer accounts. By these means, Hanover avoided further charges to net capital, allowing it to "deceive Adler and the regulators into believing that it was in net capital compliance." *Decision*, 247 B.R. at 69. Hanover posted $ 3.3 million worth of these fake "buys" between February 13 and 16, 1995 involving 31 customer accounts [7]. At the same time, Hanover booked a further $ 9.8 million in "buys" that were later cancelled. The

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[7] The Bankruptcy Court found that these "buys" were fake on the following grounds: (1) no one ever paid for them; (2) customers representing 75% of the "buys" by dollar value denied that they ordered them and no customers acknowledged ordering them; (3) Hanover booked 70% of those "buys" by dollar value in closed accounts, dormant accounts and accounts with no assets and/or no activity while Hanover cleared through Adler; (4) the remaining "buys" were at unprecedented levels in the accounts where Hanover booked them; (5) the average "buy" in those accounts was almost four times the average House Stock purchase by Hanover customers prior to the Final Week; and (6) Hanover masked a portion of the fake buys by booking $ 2.7 million of fake sales in customer accounts credited with fake buys to make it appear that there was sufficient cash in those accounts. *See id.* at 69-70 (citations omitted).

bankruptcy court also found these cancelled trades to be fake, and that "Hanover effected them to further its deceptive and illegal actions." *Id.*

[**18] Even counting these deceptive transactions and using Hanover's posted prices, the bankruptcy court found that Hanover was still at least $ 2 million out of net capital compliance by February 16, 1995. If the fake and cancelled buys were removed from the calculation, Hanover's net capital deficiency on February 16 amounted to approximately $ 6 million. Hanover [*421] neither reported its violation of the net capital rule to Adler (as was required by the Clearing Agreement) nor to NASD, and the bankruptcy court found that neither party was otherwise aware of Hanover's true financial condition. [8] On this basis, the bankruptcy court concluded that had NASD known of Hanover's capital deficiency, it would have closed Hanover on February 16, 1995.

[**19] D. *HANOVER'S FINAL WEEK*

During the Final Week, Hanover continued to purchase House Stocks and recorded $ 59.2 million worth of House Stock "buys" in its customers' accounts. Of this amount, Hanover cancelled $ 7.7 million of the purchases before they closed. The bankruptcy court found $ 45.1 million of these "buys" were fake (the "Fake Buys"). [9]

[**20] In order to conceal the Fake Buys from Adler, Hanover took steps both to make it appear that the particular accounts contained enough money for the purchases and also to ensure that the customers were not informed of the "buys", so as to prevent the customers from complaining to Adler. To these ends, Hanover booked illegal short sales (the "Fake Short Sales") in some customer accounts. Though these customers did not own, borrow, or intend to borrow the securities, Hanover booked sales of predominately Blue Chip securities in their accounts. These sales made it appear that the accounts held $ 15.1 million in cash, "proceeds" that theoretically could be used to purchase House Stocks. To ensure that the customers did not find out about this activity and possibly complain to Adler, Hanover submitted phony customer address changes to Adler. That way, when Adler sent confirmations of the trades, the statements would never reach the actual customers. Additional fraudulent activity Hanover engaged in during this period included booking trades into accounts that customers had directed to be closed or into accounts opened without customer authorization, as well as entering additional fake buys [**21] into Hanover's proprietary accounts.

During the Final Week, only 9% of Hanover's 5900 customers were able to sell their House Stocks, while many more attempted unsuccessfully to do so and complained that Hanover refused to execute their sales orders. Hanover, however, booked a total of $ 31.5 million worth of [*422] cash credits representing House Stock sales into its customers' accounts, including the small number of customers who were actually able to communicate sell orders. The bankruptcy court found that some Claimants admitted that they did not authorize the House Stock sales and/or Blue Chip Buys and that others submitted documents to the Trustee containing admissions that they were unaware that Hanover had booked the Challenged Trades in their accounts. The court concluded that others, presumably including Appellants, submitted sufficient documentation supporting their contention that they authorized the Challenged Trades. [10]

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[8] Appellants contend that Adler did, in fact, know of Hanover's financial peril and fraudulent activities. *See* Appellants' Brief at 20. However, as discussed below, the bankruptcy court's factual findings reject this assertion. *See Decision*, 247 B.R. at 70.

[9] The court cited the following reasons in support of its finding: (1) customers explicitly denied making 90% ($ 40.4 million) of the Fake Buys, and no customer acknowledged any of the transactions as a real purchase; (2) at least two Hanover brokers whose accounts were booked with Fake Buys denied that they effected those trades; (3) Hanover brokers took the Fifth Amendment when they were questioned about those trades; (4) $ 10.8 million worth of those "buys" were recorded with Hanover brokers who were not working at Hanover when the buys allegedly took place in their customers' accounts; (5) over 77% of the dollar value of the "buys" occurred in accounts that never before had any trading activity cleared by Adler, and the average "buy" in those accounts was more than ten times the average House Stock buy in all Hanover accounts prior to the Final Week; (6) the "buys" booked in 42 of the accounts, or over 22% of the dollar value ($ 10.1 million) were at least five times higher than other buys or sells in those accounts; (7) the purchase volume of House Stocks during the Final Week was greater than any other five-day period in Hanover's trading history with Adler; (8) the accounts in which Hanover recorded the Fake Buys contained in aggregate approximately $ 300,000 in cash and securities; and (9) Hanover made several attempts to conceal the Fake Buys from Adler. *See* 247 B.R. at 70-71 (citations omitted).

[10] The bankruptcy court's summary of the evidence supporting Appellants' authorization of the Challenged Trades is set forth

[**22] During the Final Week, Hanover purchased $ 18.7 million [11] [**23] in Blue Chip securities on behalf of the Claimants, including Appellants. Of these purchases, 80% occurred in the last 90 minutes [12] before Hanover closed permanently on February 24, 1995. The bankruptcy court described this activity during the Final Week as "unprecedented." *Decision*, 247 B.R. at 79. According to the bankruptcy court, the accounts chosen by Hanover to purchase Blue Chip securities were not picked at random. Rather, "Hanover booked those Blue Chip buys in accounts where the 'proceeds' of the House Stock 'sales' exceeded $ 100,000." *Id.* Hanover brokers, realizing the company's fate, attempted to protect these customers' investments by converting cash in their accounts to securities. *See id.* SIPA differentiates between claims for cash and claims for securities, protecting the former up to $ 100,000.00, but the latter up to $ 500,000.00. *See* 15 U.S.C. § 78fff-3(a). By converting cash to securities, Hanover maximized these customers' potential claims "in the inevitable liquidation proceeding." *Decision*, 247 B.R. at 79.

Most of the Blue Chip securities purchased by Hanover for its customers were purchased at significantly higher levels than at any previous time in Hanover's existence. According to the bankruptcy court, almost all (94%) of the Blue Chip Buys were concentrated in eight securities. [13] Many of these securities had never been purchased by the customers through their Hanover accounts, and purchases of the remaining 6% of Blue Chip securities by Hanover customers prior to the Final Week totaled only $ 194,553.00.

[**24] E. *THE CLOSING OF HANOVER AND ADLER*

At approximately 11:00 a.m. on February 24, 1995, NASD closed Hanover. Two [*423] days later, on February 26, Adler was forced to close under orders from NYSE.

F. *PRIOR PROCEEDINGS*

On February 27, 1995 (the "Filing Date"), SIPC commenced a SIPA liquidation proceeding against Adler in this Court under 15 U.S.C. § 78eee(b). Judge Loretta A. Preska found that Adler's customers required protection under SIPA and entered an order pursuant to SIPA § 5(b) appointing the Trustee for the liquidation of Adler and removing the case to the bankruptcy court. The proceedings in bankruptcy court, over which Judge James L. Garrity presided, culminated in the granting of a partial motion for summary judgment in favor of the Trustee with regard to 65 Claimants, including Appellants, who asserted claims based on certain trades that Hanover purported to execute on February 24, 1995. *See Mishkin v. Ensminger (In re Adler, Coleman Clearing Corp.)*, 218 B.R. 13 (Bankr. S.D.N.Y. 1998) (herein, "*Ensminger II*"). [14] A trial before Judge Garrity followed between March 13 and March 20, 1998 with respect to claims pertaining [**25] to the remaining Challenged Trades. After the trial, Judge Garrity upheld the Trustee's denial of the claims of some of the Claimants because they failed to establish that they authorized Hanover to execute their Challenged Sales or because they did not have sufficient funds in their accounts to pay for the Blue Chip Buys. In any event, the Court sustained the denial of claims as against all Claimants on the grounds that (1) under the Clearance Agreement the Trustee could cancel the Challenged Trades and (2) pursuant to applicable SIPC Rules, the Trustee could avoid the Challenged Trades as

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at pages 80-82 of the Decision. *See id.*, 247 B.R. at 80-82. While the court found circumstantial evidence contradicting the Claimants' assertions, it made credibility determinations in Claimants' favor, particularly in light of their sworn testimony that they give advance authorization for the Challenged Trades. *See id.*

[11] The bankruptcy court cites two different figures for the total amount of the Blue Chip Buys during the Final Week. On page 72 of the *Decision* the amount is given as $ 18.7 million while on page 106 the amount indicated is $ 13.3 million. *See Decision*, 247 B.R. at 72, 106. The source cited for the higher figure is the Declaration of John P. Norris, the Trustee's expert, while the lower number is traced to Trustee Exhibit 770. *See id.*

[12] The bankruptcy court cites the duration of Hanover's operations on February 24 as 90 minutes on page 72 of the *Decision* and as 40 minutes on page 81. *See Decision*, 247 B.R. at 72, 81. *id.* This Court concludes that the 90 minutes reference was the one intended because on page 73 the *Decision* indicates that Hanover was closed by its regulators at approximately 11:00 a.m. on February 24, 1995. *See id.* at 72-73; 81.

[13] These Blue Chips were Apple, Dell, Ford, Cisco Systems, IBM, AT&T, Birmingham Steel and Microsoft. *See id.*

[14] As discussed below, the Trustee's motion for partial summary judgment pertained only to the Challenged Trades that occurred on February 24, 1995, as to which Adler did not send confirmations to the customers. Judge Garrity issued his ruling on that motion on March 13, 1998, just prior to the commencement of the trial.

fraudulent transfers and/or rescind them as illegal contracts. The bankruptcy court's rulings, which granted the relief the Trustee sought, gave rise to this appeal.

[**26] **II. *STANDARD OF REVIEW***

On an appeal to the District Court from a bankruptcy court's final order or judgment the bankruptcy court's conclusions of law are reviewed de novo. *See In re Arochem Corp.*, 176 F.3d 610, 620 (2d Cir. 1999); *National Union Fire Ins. Co. of Pittsburgh v. Bonnanzio (In re Bonnanzio)*, 91 F.3d 296, 300 (2nd Cir. 1996).

The bankruptcy court's findings of facts, however, are reviewed for clear error. The applicable standard is set forth in Fed. R. Bankr. P 8013, which provides: "Findings of fact, whether based on oral or documentary evidence, shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the bankruptcy court to judge the credibility of the witness." A finding is clearly erroneous "when although there is evidence to support it, the reviewing court on the evidence is left with the definite and firm conviction that a mistake has been committed." *United States v. United States Gypsum Co.*, 333 U.S. 364, 395, 92 L. Ed. 746, 68 S. Ct. 525, (1948); *Metzen v. United States*, 19 F.3d 795, 797 (2d Cir. 1994).

The Supreme Court has articulated [**27] guidance for proper application of the clearly erroneous standard. "This standard plainly does not entitle a reviewing court to reverse the finding of the trier of fact simply because it is convinced that it would have decided the case differently." *Anderson v. Bessemer City N.C.*, 470 U.S. 564, 573-74, [*424] 84 L. Ed. 2d 518, 105 S. Ct. 1504 (1985). Factual findings must be upheld if "plausible in light of the record viewed in its entirety." *Id.* Moreover, "where there are two permissible views of the evidence, the factfinder's choice between them cannot be clearly erroneous." *Id.* In elaborating on the standard, the Supreme Court recognized the practicalities and limitations of appellate review of factual determinations. "Duplication of the trial judge's efforts in the court of appeals would very likely contribute only negligibly to the accuracy of fact determination at a huge cost in diversion of judicial resources." *Id.* at 574.

Appellants state that the only factual issues relevant to this appeal are: (1) the value Appellants gave to Adler in exchange for the transfers sought to be avoided; (2) Adler's intent to effectuate buy-ins of the short [**28] positions of the Illegal Short Sellers; and (3) Adler's knowledge of Hanover's fraudulent trading practices and inability to pay for its purchases of House Stock. *See* Appellants' Brief at 4. Appellants, however, assert error of both fact and law in the bankruptcy court's rulings in regards to thirteen specific issues they claim are presented on this appeal. *See id.* at 2-3. The factual issues and errors Appellants raise are considered separately in the discussion below. Upon a full review of the record, this Court finds no clear errors in the bankruptcy court's findings of fact. Accordingly, the court adopts the foregoing recitation as setting forth the facts pertinent to the Court's treatment of the legal issues Appellants cite.

III. *DISCUSSION*

A. *THE PARTIAL SUMMARY JUDGMENT MOTION*

1. *Appellants' Claims and the Bankruptcy Court's Rulings*

Appellants take issue with the bankruptcy court's granting the Trustee's motion for partial summary judgment and subsequently declining to alter its decision so as to deny the motion. The Trustee's motion related to his disallowance of claims arising out of Appellants' February 24, 1995 Trades that Adler refused to [**29] confirm. Judge Garrity held that Claimants were not entitled to customer claims for cash or securities under SIPC Rules §§ 300.501 through 300.503 (the "Series 500 Rules"), 17 C.F.R. §§ 300.501-503 (2001). [15] [**31] This [*425] ruling was

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[15] The Series 500 Rules determine whether a customer has a claim for cash or a claim for securities under SIPA. Rules were adopted by the SEC in 1988. Under SIPA, SIPC Rules as promulgated by the SEC are considered legislative rather than interpretive and have the full force and effect of law. *See* 15 U.S.C. § 78ccc; *see also* H.R. Rep. No. 95-746, 95th Cong., 1st Sess. 25 (1977). SIPC Rule 300.501 provides in relevant part that:

> (a) Where a SIPC member ("Debtor") held securities in an account for a customer, the customer has a "claim for cash" with respect to any authorized securities sale:
>
> (1) If the Debtor has sent written confirmation to the customer that the securities in question have been sold for or purchased from the customer's account; or
>
> (2) Whether or not such a written confirmation has been sent, if the securities in question have become the subject of a completed or executory contract for sale for or purchase from the account.

17 C.F.R. 300.501. Rule 300.502 provides in relevant part that:

> (a) Where the Debtor held cash in an account for a

based on the bankruptcy court's finding that Adler had retrieved and cancelled the confirmations of the transactions before Claimants received them, and that, under applicable New York law, the cancellation of the confirmations prevented the February 24 Trades from becoming the subject of completed or executory contracts with Adler. [16] *See Decision*, 247 B.R. at 75; *Ensminger II*, 218 B.R. at 19. The court held that trade confirmation is tantamount to acceptance of an offer. It construed New York's Statute of Frauds, § 8-319(a) of the New York Uniform Commercial Code (the "N.Y.U.C.C."), to require that a securities customer must have received written confirmation of a trade before a contract enforceable against the broker can form. *See* N.Y.U.C.C. § 8-319(a) (McKinney 1990); *Decision*, 247 B.R. at 75, 78. [17] Thus, pursuant to Adler's Customer Agreements, whether or not executed [**30] by the customers, Adler could create a contractual obligation enforceable against it by the customer only upon Adler's transmittal of a written confirmation to the customer. *See id.; Ensminger II*, 218 B.R. at 24.

[**32] In ruling upon post-trial motions, the bankruptcy court denied Claimants' request pursuant to Fed. R. Civ. P. 54(b) to revise the court's earlier decision and to deny the partial summary judgment granted to the Trustee. Finding that Claimants' arguments had raised no issue sufficient to compel modification of its conclusions, the bankruptcy court reaffirmed its *Ensminger II* ruling. See *Decision*, 247 B.R. at 74-75.

On appeal before this Court, Appellants renew their challenge to the bankruptcy [*426] court's summary judgment decision. First, Appellants contend that their February 24 Trades at issue are governed by the SIPC Series 500 Rules, which offer two alternative means by which a customer may establish entitlement to the protection and benefits of SIPA and SIPC Rules: either receipt of written confirmation of their trades *or* sufficient evidence that the relevant securities have become the subject of a "completed or executory contract" for purchase or sale. *See* 17 C.F.R. § 300.502(a)(2). Appellants assert that (1) for SIPA purposes a contract for the sale or purchase of securities forms on the trade date when the customer places [**33] an order and the broker executes the transaction and logs it in its computer records and other books and (2) such book entry evidence is sufficient to consummate a securities contract, thereby rendering proof of the delivery of a written confirmation to the customer unnecessary. Appellants maintain that the bankruptcy court erred in

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customer, the customer has a "claim for securities" with respect to any authorized securities purchase:

> (1) If the Debtor has sent written confirmation to the customer that the securities in question have been purchased for or sold to the customer's account; or
>
> (2) Whether or not such a written confirmation has been sent, if the securities in question have become the subject of a completed or executory contract for sale for or purchase from the account.

17 C.F.R. § 300.502. Rule 300.503 provides in relevant part that "nothing in these series 500 rules shall be construed as limiting the rights of a trustee in a liquidation proceeding under the Act to avoid any securities transaction as fraudulent, preferential, or otherwise voidable under applicable law". 17 C.F.R. § 300.503.

[16] This issue pertains only to the February 24 Trades and not to the balance of the Challenged Trades because Adler produced and sent written confirmations for all trades that Hanover effected on or prior to February 23, 1995. *See Decision*, 247 B.R. at 74. The Trustee challenged the validity of those earlier transactions, as well as the February 24 Trades themselves, on separate grounds described below.

[17] Section 8-319 is contained in New York's version of the Uniform Commercial Code. That section, entitled "Statute of Frauds", provides, in pertinent part:

> A contract for the sale of securities is not enforceable by way of action or defense unless
>
> (a) there is some writing signed by the party against whom enforcement is sought or by his authorized agent or broker sufficient to indicate that a contract has been made for sale of a stated quantity of described securities at a defined or stated price. . . .

Id. In 1997, the New York State Legislature amended article 8 of the Uniform Commercial Code to streamline the rules applicable to securities transactions. *See* McKinney's Session Laws of New York L. 1997, ch. 566 at 2532 (passed September 10, 1997). This amendment essentially rendered the Statute of Frauds inapplicable to securities trade. In signing the bill, Governor Pataki noted that the amended statute recognizes current practices of the securities industry under which book entry delivery of stocks occurs without the physical movement of stock certificates. *See id.* at 1950. The effect of these amendments to Article 8, enacted after the Challenged Trades here were completed, lends further support to Judge Garrity's conclusion that under the text of the New York Statute of Frauds then in effect, absent Adler's written trade confirmations, Appellants' purported House Stock Sales did not give rise to enforceable securities contracts. Had prior law been understood to recognize book entry alone to suffice to satisfy the Statute of Frauds, as Appellants argue, the 1997 amendments to Article 8 would have been unnecessary.

rejecting their arguments and by ruling instead that no contract had formed between Appellants and Adler because Adler had cancelled its written confirmations before the trades settled.

Second, Appellants argue that the bankruptcy court misconstrued paragraph 8(a) of Adler's Standard Form Customer Agreement and misapplied § 8-319 of the N.Y.U.C.C. Appellants contend that the bankruptcy court effectively established a condition precedent to the formation of a securities contract by requiring customer receipt of a written confirmation and absence of timely objection as a basis for the existence of an enforceable agreement.

Paragraph 8(a) of Adler's Customer Agreement provides that

> the confirmation of the receipt or execution of an order shall be conclusive and binding upon the undersigned [customer] if the undersigned does not object thereto [**34] in writing within five business days after Adler Coleman has sent the confirmation to the undersigned by mail or otherwise.

See Customer Agreement P 8(a) (Trustee Ex. 66); *see* also *Decision*, 247 B.R. at 76; *Ensminger II*, 218 B.R. at 24-25. In the bankruptcy court's interpretation of this paragraph, Adler was not required to clear and settle any trade until the customer both received a written confirmation and failed to object in a timely manner. *See Decision*, 247 B.R. at 76. This construction of paragraph 8(a) of the Customer Agreement served as the basis for the court's holding that Appellants' February 24 Trades did not comply with the requirements of N.Y.U.C.C. § 8-319(a).

Appellants hold that § 8-319(a) contains the requisite elements to enforce a securities contract in New York and that the provision contains no reference to a requirement of actual receipt of the writing by the party seeking the enforcement. They read the statute to require merely that such writing exist, and that here the various transmissions of trade orders from Hanover to Adler and their recording on Adler's computer records and booking [**35] in the customers' accounts constitute sufficient evidence of the existence of the customers' contracts without the necessity of delivery by Adler of the written confirmations.

Appellants further argue that even if no contract with Adler formed, the bankruptcy court also erred by holding that only a contract between a customer and a debtor satisfies the Series 500 Rules. In Appellants' view, the Series 500 Rules do not specify that the contract must be with a "debtor". Accordingly, here, where Adler was a clearing broker, the Rules could be satisfied by the customers' securities contracts with Hanover, the introducing broker, and by Hanover's related agreements [*427] with Adler, as clearing house, of which Appellants claim to be third party beneficiaries. Appellants' argument therefore posits that the "completed or executory contract" language of the series 500 Rules requires only that "a" contract exist, without specifying that such contract must be with the debtor. *See* 17 C.F.R. §§ 300.501-502. Appellants allege that the bankruptcy court's ruling effectively reads the word "debtor" into the Series 500 Rules.

Finally, Appellants assert procedural errors [**36] in the bankruptcy court's rulings. They contend that the court improvidently granted summary judgment to the Trustee by ignoring issues of fact that Claimants' responses presented and by resolving ambiguities against the non-movants. Specifically, Appellants point out that the Trustee's cross motion for partial judgment rested solely on two arguments: that (1) Adler had decided not to clear and settle and affirmatively to cancel the February 24 Trades and (2) the trades were unenforceable under the New York Statute Frauds because § 8-319(a) required the Claimants, in order to establish the existence of enforceable contracts, to possess written confirmations of the transactions. Nonetheless, according to Appellants, the bankruptcy court, while acknowledging that the evidence demonstrated that Adler had not cancelled the trades, ruled on the basis of its interpretation of paragraph 8(a) of the Customer Agreement that no contracts actually formed for Adler to cancel.

Appellants claim that because the Trustee had not raised this "no-contract-formed" issue in his motion, the bankruptcy court could not sua sponte rely on it as the basis for its decision, in doing so denying the Appellants [**37] of an opportunity to respond to the court's interpretation of paragraph 8(a). *See* Appellants' Brief at 44-45; *Decision*, 247 B.R. at 74-75; *Ensminger II*, 218 B.R. at 27. In contesting Judge Garrity's determination that under paragraph 8(a) of the Customer Agreement Adler did not intend to be bound by the Customer Agreement, Appellants argue the court erroneously made findings of fact with regard to these issues by drawing inferences against, rather than in favor of Appellants as non-movants. *See* Appellants' Brief at 46.

On this appeal, the Trustee and SIPC do not address

Appellants' challenge to that portion of the bankruptcy court's decision granting partial summary judgment. *See* Trustee's Brief at 25. In their view, questions as to whether contracts formed with respect to these trades for which Adler never sent confirmations, and whether or not Appellants failed to establish claims for the Blue Chips even if the Challenged Sales were held valid, are "academic" because the issues are not fully dispositive of this entire matter, whereas the various other grounds based on fraud asserted by the Trustee would comprehensively defeat Appellants' [**38] claims to all of the Challenged Trades. *See* 218 B.R. at 25-26.

Regarding these issues, the bankruptcy court's Decision methodically considers and disposes of each of Appellants' arguments in extensive detail and by persuasive reasoning. Although the Trustee has declined to square the issue on this appeal, and the Court concurs that the matter is not entirely dispositive of this proceeding, the Court believes it is nonetheless appropriate to respond to Appellants' challenge to this aspect of the bankruptcy court's ruling. For the reasons Judge Garrity articulates, this Court concludes that the bankruptcy court properly granted the Trustee's partial motion for summary judgment.

[*428] 2. *Contract Formation*

Appellants cite no authority persuasively supporting their contention that in the context of securities transactions subject to N.Y.U.C.C. § 319, delivery of a writing confirming the trade and creating the contract is not required. To the extent applicable principles exist in New York case law, *Schwartz v. Greenberg*, 304 N.Y. 250, 107 N.E.2d 65 (1952), upon which the bankruptcy court relied, is more closely analogous than the cases from other areas of [**39] the law Appellants adduce. *Schwartz* held, in relevant part, that in the absence of delivery of an appropriately executed contract to the party seeking enforcement, the mere existence of a signed writing is insufficient to evidence formation of a contract when the parties manifest an intent to be bound only upon the delivery of the written document. *See also Durable v. Twin County Grocers*, 839 F. Supp. 257, 260 (S.D.N.Y. 1993)("where a writing sent by the party to be bound to the other specifically indicates that an additional agreed-upon writing is contemplated prior to entry into a binding contract, this indication of intent should be honored.") (citing *Arcadian Phosphates v. Arcadian Corp.*, 884 F.2d 69, 72-73 (2d Cir. 1989)); *accord Winston v. Mediafare Entertainment Corp.*, 777 F.2d 78 (2d Cir. 1985).

The evidence here supports the bankruptcy court's determination that in the Customer Agreement or through their course of dealings the parties expressed an intent to be bound only upon Adler's transmission of written trade confirmations to the customers. By virtue of the three-way relationship that existed here, the trade confirmation, [**40] as Judge Garrity noted, was the only communication that ever occurred between Adler and the Claimants. *See Ensminger II*, 218 B.R. at 25. Absent Adler's ability to determine contract formation through transmission of the written confirmations, Hanover would have been in the position to form securities contracts for its customers binding upon Adler by unilaterally entering the trades into Adler's books, without Adler having any ability to protect itself against transactions that were not in its interest, contrary to the provisions of the Clearing Agreement. *See* Clearing Agreement P 3b (Trustee's Ex. 771). To recognize such unilateral book-entries by themselves as sufficient to form contracts enforceable against Adler would effectively permit Adler to be entrapped into obligations it never intended. *See Teachers Ins. & Annuity Ass'n v. Tribune Co.*, 670 F. Supp. 491, 497-99 (S.D.N.Y. 1987).

Appellants rely heavily on *Murray v. McGraw (In re Bell & Beckwith)*, 821 F.2d 333 (6th Cir. 1987) for the proposition that a securities customer's rights and obligations, and therefore a customer claim under SIPA, become fixed on the trade date, [**41] and that the bankruptcy court's holding to the contrary is inconsistent with that case and the Series 500 Rules. This Court disagrees. As more fully described below, the broker relationships, type of trades and underlying fraud prevailing in the case at bar are all distinguishable from the fact pattern the *Bell & Beckwith* court addressed before the Series 500 Rules were promulgated. *See* discussion *infra* Part III.A.3.a.

Second, the bankruptcy court rejected Appellants' argument that the Rules require only that the securities in question be the subject of "a" completed or executory contract, rather than only a contract with the debtor. The Series 500 Rules and SIPA, as the court observed, address claims against a debtor and its fund of customer property. *See Decision*, 247 B.R. at 77. [*429]

Rule 300.502(a)(2) provides that "where *the Debtor held cash in an account for a customer*" the customer has a "claim for securities", whether or not a written confirmation has been sent, if the securities in question satisfy three conditions: they must have become the subject of (1) a completed or executory contract; (2) for sale or purchase of securities; (3) from " [**42] *the* *account*". 17 C.F.R. § 300.502(a) (emphasis added); *see also In re A.R. Baron Co., Inc.*, 226 B.R. 790, 796 (Bankr. S.D.N.Y. 1998) (where the debtor did not issue a written confirmation of sale and there was no evidence of a completed or executory contract for the sale of securities, the claimant was not entitled to preferred SIPA customer status). Regarding the requirement that the securities contract must be for "sale or purchase" of particular securities, the broker which satisfies that criterion in this case is Adler, as clearing house. As Appellants concede, for SIPA purposes customers introduced to a clearing broker are deemed customers of the clearing broker, and not of the introducing broker. *See* Appellants' Brief at 11; *see also Arford v. Miller (In Re Stratton Oakmont, Inc.)*, 239 B.R. 698, 701-02 (S.D.N.Y. 1990), *aff'd*, 210 F.3d 420 (2d Cir. 2000).

It is thus Adler's Customer Agreement and the transaction documents generated for each specific securities sale or purchase that constitute the basis for a relevant contract. "The account" from which the relevant securities must become the subject [**43] of a contract can only be the same account which the lead paragraph of the Rule specifies is held by "the Debtor" for a customer. Like the bankruptcy court, this Court fails to see how a customer could have an enforceable preferred SIPA claim against a debtor, payable out of a pool of funds available to pay all of the debtor's eligible creditors, absent an enforceable obligation against that debtor. *See Decision*, 247 B.R. at 77.

The Court finds unconvincing Appellants' assertion that the Clearing Agreement constituted a contract qualifying for these purposes and applying to Appellants as third-party beneficiaries. The Clearing Agreement does not constitute a "contract for sale for or purchase *from the account*". 17 C.F.R. § 300.502(a)(2) (2001) (emphasis added). The Clearing Agreement is a contract between Hanover as introducing broker and Adler as clearing broker that governs the parties' respective rights and obligations. It does not purport affirmatively to define the terms of any particular customer's trade or the conditions relating to Adler's establishment and servicing of the individual customers' accounts. Appellants cite no provision [**44] of that agreement that could reasonably be construed to satisfy the language of the Rule. Moreover, the provision of Rule 300.502(a) that the debtor hold "cash in an account for a customer", 17 C.F.R. § 300.502(a), suggests as well that the qualifying contract must be one that governs the conditions of the disposition of that cash and its relation to the purchase or sale of securities from the account - - as for example the sufficiency of such cash to warrant execution of the particular trade. [18]

The Court also [**45] finds no merit in Appellants' proposition that irrevocable contracts between them and Adler could form [*430] automatically by virtue of Hanover's direct access to Adler's computer system, merely through the unilateral actions of Hanover, serving as their agent, in booking trades and recording them into Appellants' accounts at Adler, even when the transactions are indisputably fraudulent. Such a construction of the Rules would, as previously mentioned, entrap the broker into liability for obligations to which it did not intend to be bound. *See Tribune*, 670 F. Supp. at 497. It would also render clearinghouses powerless to protect against their introducing brokers' fraud and place them at the mercy of the introducing firm.

Finally, the Court finds that the bankruptcy court adequately addressed the issues raised by Appellants' procedural challenges. Judge Garrity noted that, as filed, the Trustee's motion for summary judgment clearly raised the issue of when Adler created enforceable contracts with the Claimants; that during the arguments on the Trustee's motions the Claimants protested the manner in which the Trustee had introduced the "no-contract-formed" argument, but that [**46] no Claimants sought leave to submit any additional evidence or arguments in response to it, either at the hearing or while the motion was under deliberation by the court. *See Decision*, 247 B.R. at 75. On this basis, Judge Garrity concluded that the Claimants were not prejudiced because they had ample opportunity to file legal and factual support in opposing the "no-contract-formed" theory but failed to do so. *See id.* This Court finds that Appellants have advanced no sufficient grounds to warrant disturbing the bankruptcy court's determinations in this regard.

3. *The Blue Chip Buys*

Appellants contest the bankruptcy court's ruling that they failed to establish a claim for securities under the

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[18] Under paragraph 4(b) of the Customer Agreement, customers purchasing securities were required to have "previously uncommitted, immediately available funds in an amount sufficient to pay the purchase price" of the securities they were purchasing. *See* Customer Agreement P 4(b). This provision bears upon the bankruptcy court's determination that Appellants could not make out a claim for the Blue Chip securities because they did not have sufficient funds in their accounts.

Series 500 Rules on the ground that Appellants lacked "immediately available" funds in their accounts sufficient to pay the purchase price of the Blue Chip securities. Appellants contend the court erred because (1) the required cash was in their accounts and (2) the Series 500 Rules do not require immediately available cash. *See* Appellants' Brief at 46.

The bankruptcy court found no dispute that (1) Adler maintained Hanover's proprietary account and cleared and settled [**47] Hanover's trades, whether Hanover acted as buyer or seller; (2) Hanover purported to purchase all of the House Stocks associated with the Challenged Trades; and (3) Adler's books and records showed that Adler, in executing the purchase or sale orders Hanover transmitted, (a) debited the House Stocks out of the Claimants' accounts and into Hanover's proprietary account and (b) debited the cash corresponding to the purchase price out of Hanover's proprietary account and into Claimants' accounts. *See Decision*, 247 B.R. at 82.

a. *Cash in the Accounts*

The Trustee sought to disallow the Claimants' claims for the Blue Chips because Claimants did not establish that they had sufficient funds in their accounts to pay for the securities. He maintained that, under Hanover's fraudulent scheme, the cash expected to be generated by the Challenged Sales upon settlement of the trades would be applied to pay for the securities. *See Decision*, 247 B.R. at 82. As such, there was no real cash in the Claimants' accounts because the trades never settled and the proceeds yielded by the Challenged Sales of House Stock, even at the inflated prices manipulated by Hanover, [**48] were not enough to cover the cost of the Blue Chips.

[*431] The bankruptcy court found that the record did not support the Claimants' argument. Rather, the court determined that cash proceeds of a sale of securities are not available until settlement date. *See Decision*, 247 B.R. at 84. The court concluded that although some Claimants made out a prima facie case that they held preferred SIPA customer "claims for cash" in the form of the proceeds from the Challenged Sales, they could not sustain a valid "claim for securities" in the form of the Blue Chips because the trades never settled, and because a "claim for cash" is not the equivalent of "cash" in the customer's account held by the debtor within the meaning of SIPC Rule 300.502. *Id.* at 85.

On this appeal, Appellants, again relying on *Bell & Beckwith*, maintain that a customer's sale of stock through a broker-debtor who holds possession of the stock constitutes a completed or executory contract when the account is credited, whether or not the clearing broker actually confirms it. *See* Appellants' Brief at 48. According to Appellants, the cash credit Adler posted into their accounts without delivery [**49] of actual cash was sufficient to satisfy the "cash in the account" requirement of the Series 500 Rules even if no cash was immediately available to be withdrawn, and notwithstanding the provision of the standard form Customer Agreement which required the cash necessary to purchase securities to have been "previously uncommitted, immediately available funds in an amount sufficient to pay the purchase price". Customer Agreement, P 4(b). Appellants note that only 162 of the 5660 Customer Agreements Adler possessed were signed by the customers, none of them by Appellants, and contend that it was Adler's course of business dealings to waive this provision.

In Appellants' view, recognizing cash credit entries into their accounts on the trade date as being equivalent to actual "cash in the account" preserves for customers the legitimate expectations of their bargains and would leave Appellants here "unaffected by Hanover's and Adler's collapse." Appellants' Brief at 50 (citing *Bell & Beckwith*, 821 F.2d at 339).

The bankruptcy court, rejecting the waiver argument, concluded that waiver constitutes an "intentional relinquishment of a known right." *Decision*, at 247 B.R. at 83) [**50] (quoting *Johnson v. Zerbst*, 304 U.S. 458, 464, 82 L. Ed. 1461, 58 S. Ct. 1019 (1938)). The court further found that Claimants had adduced no evidence in writing or course of dealings establishing that Adler had knowingly or intentionally waived any provision of its Customer Agreements. The court also reiterated for this purpose its earlier holding that securities contracts cannot form merely by the introducing broker's unilateral book entries of debits and credits into the customers' accounts, but, under New York law, require confirmation by the clearing broker to be enforceable.

Finally, the bankruptcy court rejected Claimants' argument that there was sufficient cash in their accounts. It found that the evidence on the record, including the testimony of Claimants' expert, established that the cash proceeds of a sale of securities are not available until settlement date and that "none of the Challenged Trades booked in the usual way settled." *Decision*, 247 B.R. at 84. According to the court, the experts agreed that "Adler's accounting records merely show pending transactions and that the booking of a transaction does not mean that the transaction [**51] had settled." *Id.*

This Court sees no clear error in this aspect of the bankruptcy court's factual findings and is persuaded that the bankruptcy [*432] court's legal determinations are supported by applicable law. The predicate for a valid "claim for securities" under Rule 300.502(a) is "cash" held by the debtor in the customer's account. *See* 17 C.F.R. § 300.502(a). In the plain meaning of the word, "cash" requires actual funds promptly available. The dictionary defines the term as "money that a person actually has, including money on deposit; ready money." *Webster's New Universal Unabridged Dictionary*, p. 280 (2d ed. 1979); *See also Black's Law Dictionary*, p. 216. (6th ed. 1990) ("money or the equivalent; usually ready money"). The concept suggests a current asset, as opposed to an expectation or claim to receive a specific sum of money in the future that may be the subject of contingencies. This right to an amount due, a correlative of debt, defines a "credit". *Black's Law Dictionary*, p. 367 (6th ed. 1990).

b. *Trade Date*

Appellants cite *Bell & Beckwith* extensively for the proposition that their sale of securities to Hanover was complete [**52] on trade date, entitling them as of that point to the legitimate expectations of their bargains. The case is distinguishable, and Appellants place unwarranted reliance on it. Because the SIPC Series 500 Rules are said to have codified the holding of *Bell and Beckwith* (*see In re Investors Ctr., Inc.*, 129 B.R. 339, 351 (Bankr. E.D.N.Y. 1991)), ample consideration of the case here is warranted. First, *Bell & Beckwith* involved a one-sided, two-party trade entailing only an order by the customer directly to its broker-debtor to sell securities. 821 F.2d at 334. The securities in question were already in the broker's account and registered in its name, so that the trade was subject to immediate execution by the broker. *See id.* On the date the customer placed the order, the broker sold a portion of the stocks to other brokers and arranged to purchase the remaining shares for its own account. *See id.* All of the transactions were reflected on trade tickets and reported to the customer the same day, with the settlement date indicated to be one week later. *See id.* The Sixth Circuit, reversing contrary determinations by the bankruptcy court and [**53] the district court, held that on trade date the customer had a claim for cash, rather than one for securities. *See id.* at 340.

The *Bell & Beckwith* situation is markedly different from the multi-dimensional transaction in the case at bar. There the customer dealt directly with the broker which executed the trade; no intermediary broker acted on behalf of the customer to enter the trade on the clearing broker's account. *See id.* at 334. The broker purchased and sold customer securities of which it already had received delivery, so that no aspect of the transaction remained unperformed other than settlement. *See id.*

Moreover, upon completion of the trade, the sales were reflected on trade tickets and reported to the customer on the same day. *See id.* In other words, to the extent confirmation of the trade represented an essential element to form a binding contract as between the primary broker and the customer, thereby committing the parties to the transaction, the circuit court suggests that step had occurred. Accordingly, the circuit court's holding is premised on the existence of fully performed and enforceable obligations on the trade [**54] date. Finally, in holding that trades ordered by customers of a debtor before filing date should be treated vis-a-vis those customers as if subsequently completed by the debtor, the *Bell & Beckwith* court impliedly assumed that the debtor-broker would be able satisfactorily to complete the transactions in relation to other brokers [*433] with which the customers dealt. *See id.* at 339. That assumption may be valid where the other brokers are solvent and capable of fulfilling obligations to the debtor. The proposition is questionable where, as here, the purchasing broker, which ordinarily would be required to cover by buying stock elsewhere (*see id.* at 338) was not only insolvent at the time but had purposely defrauded its clearing house broker-debtor.

By contrast, in the instant case, the Challenged Trades contemplated not only Appellants' sale of House Stocks to Hanover and simultaneous purchase of the Blue Chips from third parties in the relevant markets, but also a tri-lateral relationship. These interconnections involved a clearing broker-debtor, implicating Adler's performance obligations to the clearing agency of which it was a participant, and the [**55] introducing broker which unilaterally posted the trades directly into the Appellants' accounts, purportedly automatically creating Appellants' claim against Adler. The additional steps and parties involved in this more complex transaction and process implicated contractual obligations and corresponding performances toward the formation of binding securities contracts and consummation of the transactions that, as the bankruptcy court concluded, were not all in place on the trade date. This process required that the clearing broker send trade confirmations to the customers and did not contemplate that the cash necessary to effectuate delivery of the Blue Chip securities would be in the customers' accounts until settlement date. *See Matthysse v. Securities Processing Servs., Inc.*, 444 F. Supp. 1009, 1020 (S.D.N.Y. 1977) (holding that under applicable provisions of the N.Y.U.C.C., to satisfy delivery and complete a trade of securities in a three-party transaction required both book entry and receipt of confirmation by the customer).

c. *Effects of Hanover's Fraud*

An equally significant difference, in this Court's view, is the additional dimension that distinguishes [**56] and drives so much of the appeal before the Court: Hanover's far-reaching fraud. There was nothing in the *Bell & Beckwith* trades remotely resembling the fraudulent and criminal misconduct which actuated and accompanied the trades here at issue. It is the legitimate expectations of the bargains of those concededly fraudulent transactions of which Appellants seek to avail themselves.

This element makes a critical and compelling difference in this case. In the transactions Appellants seek to enforce as arms-length, good faith bargains, Appellants purportedly sold their shares of House Stocks to Hanover. Appellants' brokers at Hanover knew, however, as the bankruptcy court determined (*see Decision*, 247 B.R. at 98) that Hanover was insolvent at the time; that the prices it agreed to "pay" for its purchase of Appellants' House Stocks were fraudulently inflated by Hanover's manipulation; and that Hanover had no funds in its proprietary account at Adler with which to pay Appellants for those purchases. Nonetheless, Hanover, having independent access to its Adler customers' accounts through a direct computer link, booked the entries of the disputed "cash" credits into [**57] Appellants' accounts and corresponding debits into Hanover's own proprietary account, reflecting the transfer or delivery of the phantom "cash" here in contention.

The only way this credit could have materialized into real cash would have required Adler, itself then at the point of financial collapse, to advance the funds in the form of loans to finance Hanover's fraudulent purchases. These monies would support loans that Hanover, then in [*434] its final gasp during its chaotic closing moments, knew would never be paid. *See id.*

These loans and credits were fraudulently posted into Appellants' accounts by their brokers with no intent or ability on Hanover's part to repay them, and were effectuated unilaterally by external, automatic book entries in the records of the clearing broker which was being defrauded. It is thus Adler's purported obligation to make good on Hanover's misconduct that Appellants seek to convert into "cash" in their accounts at Adler within the meaning of the SIPA Rules. This notion of "cash", they contend, is sufficient to give them a binding claim enforceable against Adler entitling them to delivery of the Blue Chips.

Under Appellants' conception, this "cash" [**58] was enough to pay for the Blue Chips. They take exception with the bankruptcy court's ruling that paragraph 4(b) of the Customer Agreement required customers purchasing securities to have in the account "immediately available funds in an amount sufficient to pay the purchase price." Customer Agreement P 4(b). Appellants' argue that they had some cash represented by the proceeds from their sale of House Stocks to Hanover and that even if not enough to cover the full price of the Blue Chips, the cash was sufficient for Rule 300.502(a)(2) purposes. This argument ignores that the Rule assumes the existence of a complete or executory contract with respect to the particular trade from the customer's account at Adler, and that in this case, by reason of paragraph 4(b), absent sufficient funds in the account to pay for the Blue Chips' purchase price, Appellants could not possess such a completed contract.

Also overlooked in Appellants' elided view of the transactions is that the purchase of Appellants' House Stocks was simultaneously entered into their accounts by the same brokers at manipulated, artificially high prices which far exceeded the proceeds that could be expected to be derived [**59] from the fair market value of Appellants' House Stocks. Under this version of the transactions, by Appellants own account, Appellants gain the full benefit of their "legitimate bargain", as though the trades were entirely untouched by their brokers' frauds, and Appellants are left fully "unaffected by Hanover's and Adler's collapse." Appellants' Brief at 50. But in this construction of events, while Appellants come out whole, Adler and its thousands of other customers and creditors who were not specifically chosen by Hanover as beneficiaries of its fraud, are left holding the proverbial bag.

This Court believes that neither SIPA nor the SIPC Rules promulgated to carry out its protections, nor anything in *Bell & Beckwith*, countenance a legal alchemy by which fraudulent credits posted into customers' accounts from the sale of securities that the bankruptcy court found were "practically worthless" (*Decision*, 247 B.R. at 106) could be transformed into instant cash. In turn, to carry Appellants' theory to its conclusion, the purported "cash" from this conversion would immediately materialize into binding purchase contracts for delivery of brand name securities whose [**60] market worth far exceeded the fair value of the proceeds in Appellants' accounts. This operation would demand that during the transfiguration of credit into cash, the manifest improprieties in the methods the Appellants' broker-agents employed, by which the supposed "cash" materialized into the customers accounts in the first place, be overlooked, while at the same time maintaining that the entire trade be blessed as strictly arms-length, good faith and innocent.

Hanover's extensive fraud has overarching significance and implications for [*435] the transactions that culminated in the Challenged Trades that included the February 24, 1995 Blue Chip Buys. Contrary to Appellants' perceptions of these events, Hanover's deeds cannot be ignored in assessing whether Appellants are entitled to enforce the Challenged Trades. While it is true that one of SIPA's primary objectives is to protect individual customers from financial hardship, the legislation also embodies parallel and complementary aims intended

> to insulate the economy from disruption which can follow the failure of major financial institutions; *and to achieve a general upgrading of financial responsibility requirements of brokers* [**61] *and dealers to eliminate, to the maximum extent possible, the risks which lead to customer loss.*

H.R. Rep. 91-1218, at 4 (1970) (emphasis added); *see also* H.R. Rep. No. 91-1613, at 1 (1970); *SIPC v. Barbour*, 421 U.S. 412, 95 S. Ct. 1733, 44 L. Ed. 2d 263 (1975).

The SIPC 500 Rules, promulgated in 1988, two years after *Bell & Beckwith* was decided, reflect these ends. They safeguard securities customers' legitimate claims to cash and securities held by the debtor in their accounts prior to filing date, and also manifest a design to deny protection to transactions tainted by fraud. SIPC Rule 300.503(a) excludes such fraudulent claims. [19] *See* 17 C.F.R. § 300.503.

[**62] B. *CANCELLATION OF TRADES PURSUANT TO PROVISIONS OF CONTRACTS*

The bankruptcy court sustained the Trustee's contention that he was entitled to invoke contractual rights flowing from paragraph 3(b) of the Clearing Agreement as grounds for cancelling the Challenged Trades. That provision states that Adler may, if it has reasonable grounds to believe such action is necessary to protect its interests,

> refuse to open an account for a specific customer, close an account already opened; refuse to confirm a transaction; cancel a confirmation of a transaction; refuse delivery or receipt of any cash, securities or other property; refuse to clear any transaction executed by [the introducing firm]; or refuse to execute any transaction for an Introduced Account (notwithstanding its acceptance by the Introducing Firm pursuant to Paragraph 5(d)). [Adler] shall use its best efforts to notify [the introducing firm] of any such action in advance thereof if it is able to do so without jeopardizing its economic interest….

Clearing Agreement, P 3(b). The Customer Agreement contains a similar provision defining Adler's rights as against customers. *See* Customer Agreement, [**63] P 5(b).

Appellants argue, parallel to their views regarding the formation of securities contracts for SIPA purposes, that SIPA and the SIPC Series 500 Rules govern the establishment of customer claims and contain the exclusive remedies to address the Trustee's claims. In essence, Appellants assert that federal law preempts the application of Adler's contractual rights here. In support of this federal law supremacy theory, Appellants cite *Investors Ctr.*, 129 B.R. 339, and *Bell & Beckwith*, 821 F.2d 333. [*436]

The trustee in *Investors Ctr.* sought to deny customers' claims under the Series 500 Rules on the grounds that the clearinghouse broker-debtor, having already sent to the customers confirmations of the securities sales they sought to enforce, subsequently purported to reverse the transactions by sending cancellation notices, as instructed by the debtor, when the debtor realized that it had no funds to pay for the purchases. Appellants stress

[19] Rule 300.503(a) provides that:

> Nothing in these Series 500 Rules shall be construed as limiting the rights of a trustee in a liquidation proceeding under the Act to avoid any securities transaction as fraudulent, preferential, or otherwise voidable under applicable law.

17 C.F.R. § 300.503.

that the Series 500 Rules were designed to provide a bright line test to determine when a customer has established a claim for cash or for securities, and that the bright line is satisfied, consistent with [**64] *Bell & Beckwith*, on the trade date when the purchase or sale is completed. Appellants also assert that the relevant language of the Clearing Agreement grants the Trustee the right to cancel a confirmation of a trade, and not the underlying executed or completed transaction.

The authorities upon which Appellants' argument relies do not endorse the expansive preemption theory Appellants assert. By implication, under Appellants' proposition, federal law would not only establish exclusive rules governing the formation of a securities contract, but would similarly override any express contractual rights pertaining to the cancellation of contracts that the parties may have negotiated to protect their interests from precisely the type of wrongful acts evidenced here. This Court does not read that purpose in SIPA or the SIPC Rules. In fact, the Series 500 Rules contemplate the application of contract law principles. SIPC Rule 300.502(2) explicitly does so by providing that whether or not the broker has sent written confirmations the customer has a "claim for securities" if the securities in question "have become the subject of a completed or executory contract." 17 C.F.R. § 300.502(a)(2) [**65] ; *see Baron*, 226 B.R. at 796; *Ensminger II*, 218 B.R. at 26.

In *Bell & Beckwith*, 821 F.2d at 338, the Sixth Circuit noted that it was concerned with "a transaction that was interrupted by the operation of federal law," specifically a bankruptcy filing under SIPA. Such transactions, the court concluded, "must ultimately be defined as a matter of federal law, because SIPA alters the rights of the parties in a way not contemplated by the U.C.C." *Id.* However, the "dispositive issue" the court there identified entailed specifically whether "this contract should be characterized as 'wholly executory'". *Id.* at 336. There is no indication in the circuit court's opinion that the trades in question were assailable under the terms of any other contractual commitments between the parties. *Bell & Beckwith* thus presupposes the existence of a contract otherwise valid that had already come into force and whose completion was interrupted by the bankruptcy filing. As regards such contracts, *Bell & Beckwith* stands for the proposition that under federal securities law, trade date rather than settlement date "fixes the rights [**66] of the parties" to a transaction interrupted by a SIPA filing. *Id.* at 338.

Consequently, as discussed above, the case did not deal with the prerequisites for the *formation* of a contract, the elements of which presumably would still be governed by contract principles defined by applicable law. By the same token, because the case assumes the existence of a contract whose enforcement was not contested on other grounds, the court did not consider the circumstances under which, absent confirmations that would have satisfied Rule 300.502(a)(1), *cancellation* of a securities contract may be permissible on an independent basis in accordance with the relevant terms defining the parties' rights and obligations relating to such a contract.

[*437] The second case upon which Appellants rest their preemption theory indirectly references this issue, and suggests an outcome which does not support Appellants' contentions. The court in *Investors Ctr.* held that the debtor's purported cancellation of the trades did not deprive the customers of their claims for cash from their sales of stock because, under SIPC's Rule 300.501(a)(1), the customers already had been sent a "written [**67] confirmation" of their sales, whose finality could not be erased by the later notice. 129 B.R. at 349-50. At the moment of transmission, that first confirmation fixed the customers' rights by operation of SIPA, regardless of the parties' other underlying contractual rights and obligations. *See id.* at 350. The court, however, assumed that such other contractual rights did exist, potentially also giving the customers a claim for breach of contract against the broker based on the attempted cancellation of the trades. *See id.* at 351.

In other words, to the extent the SIPC Rules provided for customers' rights to claims for cash to become binding upon trade confirmation, the Rules superseded the parties' other contractual relations to the contrary. Relevant to the issue at hand, the court acknowledged that had the customers not been entitled to the protection of Rule 300.501(a)(1) by reason of the written confirmations sent to them, the provision of Rule 300.501(a)(2) defining the alternative basis for a claim for cash - - the securities in question having become the subject of a completed and executory contract - - would have operated to deny [**68] the customers' claims. *See id.* at 350. In that event "*the cancellation notice might have been fatal to the claims of these customers.*" *Id.* (emphasis added).

In the case at hand, because Adler sent no confirmation notices to effectuate the February 24 Trades Appellants seek to enforce, Appellants, unlike the customers in *Investors Ctr.*, must rely on the alternative "completed or executory contract" prong under Rule 300.501(a)(2) in order to establish their claim for securities. The bankruptcy court disagreed with Appellants' contention that by operation of SIPA, as applied in *Bell & Beckwith*, Appellants had completed irrevocable contracts on the trade date, concluding instead that because Adler had not sent confirmations with respect to the transactions, delivery of which was required to satisfy New York's Statute of Frauds, N.Y.U.C.C. § 8-319(c), a condition necessary to the formation of an enforceable contract in New York had not been met.

Because a predicate of Rule 300.501(a)(2) is not only the existence of a contract, but also a contract that is either completed or executory, a necessary condition could not be satisfied if the contract is precluded [**69] from becoming completed or executory by some intervening action, such as cancellation effectuated on some independent basis in accordance with the parties' underlying contractual relationship and expressed intent, or even, as the *Investors Ctr.* court recognized, as a breach by either party.

Appellants concede that paragraph 3(b) of the Clearing Agreement authorized Adler to cancel a confirmation of or refuse to confirm a trade. Insofar as under state law confirmation was an essential element of the parties' contract, Adler's retrieval of the confirmations could be read either as consistent with a decision to prevent the formation of contracts or subsequently to cancel the trades that otherwise could have ensued to settlement so as to create executed or executory contracts. Like the customers in *Investors Ctr.* whose trades were not executed, these customers may hold a claim for breach of contract, though not an enforceable SIPA claim. *See Investors* [*438] *Ctr.*, 129 B.R. at 353; *see also Baron*, 226 B.R. at 796; *Barton v. SIPC*, 182 B.R. 981, 985 (Bankr. D.N.J. 1995); *SIPC v. Oberweis Sec., Inc.*, 135 B.R. 842, 846 (Bankr. N.D. Ill. 1991). [**70]

The point that emerges from this analysis is that, absent the sending out of securities trade confirmations pursuant to Rule 300.502(a)(1), SIPC Rule 300.502(a)(2), by requiring evidence of an enforceable contract, would not operate, as Appellants' hypothesis would suggest, effectively to vitiate the entire bundle of contractual rights and obligations set forth in the parties' underlying agreements that deal with contractual prerequisites such as the principles governing formation, enforcement and cancellation of the agreement. To construe the provision as mechanically as Appellants suggest would read Rule 300.502(a)(2) out of existence, to the same extent and for comparable reasons that the *Investors Ctr.* court observed that an analogous construction of Rule 300.501(a)(1) in that case would have interpreted that provision out of the statute. *See* 129 B.R. at 350.

Appellants' theory would produce consequence that SIPA could not have contemplated. By insisting that through mechanical book entries made unilaterally by a customer's agent on the clearing broker's books, even if patently fraudulent, contracts technically formed creating irrevocable obligations for the broker, a securities [**71] customer could deprive the defrauded broker, prior to the contract's becoming executory or completed, the negotiated right to invoke permissible safeguards, such as cancellation. The broker thereby may be denied the ability to defend itself from precisely the actions or conditions that the parties contemplated the agreement would protect against, and that the customer may seek to ignore or evade.

For the foregoing reasons, this Court finds no error in the bankruptcy court's ruling that to the extent the Trustee has reasonable grounds to cancel the Challenged Trades pursuant to paragraph 3(b) of the Clearing Agreement, he is entitled to do so.

C. *AVOIDING THE TRADES AS FRAUDULENT TRANSFERS PURSUANT TO THE BANKRUPTCY CODE*

The Court turns to the Trustee's argument, sustained by bankruptcy court, that even if Appellants held binding contracts with respect to the Challenged Trades, those transactions were tainted with the massive frauds perpetrated by Hanover and its brokers against Adler and its creditors. On this basis, the Trustee maintains that the bankruptcy court properly determined that the Trustee could cancel the confirmations of the trades and/or avoid the contracts [**72] and underlying transactions as fraudulent transfers or illegal agreements under various federal and state laws.

In fact, Hanover's fraudulent conduct at issue was so pervasive, and so permeated the events, the parties' relations and the transactions at hand that, as Judge Garrity recognized, the underlying frauds cannot be disassociated from the basic issue of whether the Challenged Trades formed valid contracts. *See Decision*, 247 B.R. at 84, 97. Thus, for example, it was Adler's realization on February 24, 1995 of the full scope of Hanover's fraud that motivated Adler's decision that same day to retrieve the confirmations of the February 24 Trades before they were transmitted to the Claimants. Adler's cancellation of the confirmations in turn constituted the basis for the bankruptcy court's determinations that no contract between Adler and Appellants formed and that the Trustee, in protecting Adler's interests under the Clearing Agreement, was entitled under that [*439] Agreement to cancel the Challenged trades altogether.

The bankruptcy court found sufficient grounds to sustain the Trustee's avoidance of the Challenged Trades insofar as the transactions purported conveyance [**73] by Adler of any cash or securities to Appellants' accounts, and as to any obligation incurred by Adler to deliver any such property. The court disallowed the trades as actual fraudulent transfers under § 548(a)(1)(A) of the Bankruptcy Code (herein the "Code"), as well as constructively fraudulent trades under § 548(a)(1)(B), and granted the Trustee recovery pursuant to § 550. [20]

1. *Avoidance Pursuant TO 11 U.S.C. § 548(a)(1)(A)*

> Under § 548(a)(1)(A) a trustee
> may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor… if the debtor voluntarily or involuntarily… made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date such transfer was made or such obligation was incurred, [] indebted.

11 U.S.C. § 548(a)(1)(A).

[**74] In determining whether the Trustee could prevail in his claim to avoid the Challenged Trades pursuant to § 548(a)(1)(A), the bankruptcy court applied a three-part test reflecting the elements the Trustee had to establish. Those requirements were that (1) Hanover, rather than Adler as debtor, actually intended to hinder, delay or defraud Adler's creditors or the SIPC; (2) Hanover's fraudulent intent could be imputed to Adler because Hanover dominated or controlled Adler's disposition of its property; and (3) Hanover's fraudulent acts could also be charged to the Claimants as principals and ultimate beneficiaries of the trades conducted by Hanover as their agent.

Examining the totality of the circumstances to infer whether the fraudulent intent existed here, the bankruptcy court found that the Trustee was entitled to judgment under § 548(a)(1)(A) avoiding the transactions and restoring to the debtor's estate the property fraudulently transferred. *See Decision*, 247 B.R. at 86; *see also Mishkin v. Ensminger (In re Adler, Coleman Clearing Corp.)*, 218 B.R. 689, 704-05 (Bankr. S.D.N.Y. 1998) ("*Ensminger I*") (denying Claimants' motion to dismiss the [**75] Trustee's complaint and ruling that the Trustee's allegations were sufficient to state a claim for avoidance pursuant to § 548).

Appellants dispute each of the bankruptcy court's conclusions. They contend that as innocent customers they cannot be held vicariously liable for the fraudulent and illegal acts of their brokers under any of the agency law principles Judge Garrity applied, and charge error in the court's holding that Hanover dominated or controlled the disposition of Adler's property.

a. *Hanover's Intent to Hinder, Delay or Defraud*

The nature, purpose and full magnitude of the fraud perpetrated by the Hanover brokers in this case can be best understood in the light of the position Hanover [*440] found itself in by mid-February 1995, as the facts emerge from the voluminous evidence the bankruptcy court admitted and credited. As detailed above, Hanover, its officers and brokers, as well as relatives, friends and selected favored customers were all heavily invested in House Stocks. Because Hanover was the dominant market-maker for the House Stocks and used the value of House Stocks in its proprietary accounts to support its net capital requirements, the market prices Hanover [**76] quoted for these securities took on special importance to Hanover and its officers. *See Decision*, 247 B.R. at 68-69. In late January 1995, the posted prices for the House Stocks came under severe attack by the activities of the Illegal Short Sellers.

In response to the short selling, Hanover, rather than lowering the prices it offered for the House Stocks and thereby discouraging the Short Sellers' onslaught, supported the prices by purchasing for its own account, at Hanover's posted prices, all of the House Stocks the Short Sellers put up for sale. *See id.* at 69. Hanover's large purchases of House Stocks for its proprietary accounts had adverse implications. It forced Hanover to take charges against net capital in order to remain in

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[20] Under § 550(a), to the extent a transfer is avoided under various provisions of the Code, including § 548,

> the trustee may recover, for the benefit of the estate, the property transferred, or, if the Court so orders, the value of such property, from -- (1) the initial transferee of the transfer or the entity for whose benefit such transfer was made; or (2) any immediate or mediate transferee of such initial transferee.

11 U.S.C. § 550(a).

compliance with the SEC's net-capital rule and avoid the risk of being closed down by Hanover's regulators or by Adler. *See id.* at 68.

Faced with the prospect of net capital deficits, with the high volume of House Stocks the Short Sellers were offering and with an insufficient demand for those securities among its customers and other buyers at Hanover's high prices, Hanover devised the fraudulent scheme [**77] underlying the transactions that the Trustee sought to avoid. Hanover fabricated purchases of House Stocks and booked them into the accounts of real and fictitious customers to create the appearance that its fake acquisitions of House Stocks were matched by corresponding sales of the securities at the stated prices. *See id.* The bankruptcy court found that Hanover's purpose in booking these purchases was "to deceive Adler and the regulators into believing that it was in net capital compliance." *Id.* at 69.

The bankruptcy court also found extensive evidence establishing that during the Final Week Hanover's principal brokers sold House Stocks and purchased Blue Chips for their own accounts and for their families, friends, and favored customers to ensure that when Hanover's inevitable collapse occurred, they would hold preferred SIPA claims. *See id.* at 86-90. Aware of the nature and limitations of SIPA protections extended to customers of failed securities firms, [21] the brokers posted entries of Blue Chip purchases by Hanover on the basis of whether the expected proceeds from the customers' House Stocks sales, when applied against the cost of the [**78] Blue Chip Buys, would exceed $ 100,000.00, so that any cash position remaining in the account would be reduced below that threshold amount. *See id.* According to the evidence the bankruptcy court considered and credited, some of the Claimants were told by their Hanover brokers that they needed to shift their holdings, presumably from House Stocks to Blue Chips, in order to maximize the extent of their protection under SIPA, and some of the [*441] brokers themselves, following Hanover's closing, admitted that their actions were motivated by a purpose to vest their customers with preferred SIPA claims. *See id.* at 87.

[**79] In addition, Judge Garrity found that following Hanover's failure, a number of its brokers joined other brokerage houses, from which they solicited business from some of their former Hanover customers. *See* 247 B.R. at 89. Among the former customers contacted were four of the eight Appellants here. *See id.* at n. 55. [22] When questioned about their involvement in these transactions, Hanover's principals and brokers refused to testify and invoked their Fifth Amendment privilege against self-incrimination. *See id.* at 89.

[**80] On the basis of these factual findings of Hanover's unlawful conduct, and other undisputed evidence of Hanover's massive market manipulation, the bankruptcy court concluded that Hanover and its brokers clearly intended to hinder, delay and defraud Adler and its creditors, including SIPC. [23] *See id.* at 90 ("No one disputes that while Hanover's brokers' immediate purpose was to deceive Adler, they plainly intended for Adler's creditors, including SIPC, to be the ultimate victims of their fraud.").

[**81] During the bankruptcy court proceeding, the

[21] In a SIPA liquidation proceeding, SIPC advances funds to the trustee, limited to $ 500,000.00 per customer, of which no more than $ 100,000.00 may be based on a customer claim for cash, as opposed to securities, in order to enable the trustee to satisfy customer claims that fall within these limits. SIPC becomes subrogated to customer claims paid to the extent of such advances. *See* 15 U.S.C. §§ 78fff-3(a), 78fff-2(c)(1), and 78lll(11); *Ensminger I*, 218 B.R. 689 at 695-96.

[22] According to the Trustee, all of the Appellants were serviced by two Hanover brokers, John Lembo and Joseph DiBella. *See* Trustee's Brief at 13. Both Lembo and DiBella were indicted for securities fraud in connection with their market manipulation of House Stock prices while at Hanover. *See Decision*, 247 B.R. at 89 n. 57. Judge Garrity noted that DiBella pleaded guilty. *See id.* Lembo subsequently did as well, a fact of which this Court may take judicial notice. *See Rothman v. Gregor*, 220 F.3d 81, 92 (2d Cir. 2000). Lowell Schatzer, Hanover's titular head, refused to testify and absconded, allowing a $ 50 million default judgment to be entered against him. *See id.* at 89 n. 56. In related rulings Judge Garrity admitted evidence of the Hanover brokers' invocation of the Fifth Amendment and of their other frauds. *See Mishkin v. Ensminger (in re Adler, Coleman Clearing Corp.)*, 1998 Bankr. LEXIS 406, No. 95-08203, 1998 WL 16036 (Bankr. S.D.N.Y. April 3, 1998); *Mishkin v. Ensminger (In re Adler, Coleman Clearing Corp.)*, 1998 Bankr. LEXIS 1925, No. 95-08203, 1998 WL 182808 (Bankr. S.D.N.Y. April 17, 1998).

[23] SIPC qualifies under § 548(a)(1)(A) as an "entity to which the debtor…became… after the date that such transfer was made or such obligation was incurred, indebted" because in the event Appellants were to prevail and the Challenged Trades were sustained, SIPC would be obligated to pay for them up to the amounts of its statutory limits. It then would be subrogated to Appellants' claims against the Adler estate. *See Decision*, 247 B.R. at 90 (citing *Ensminger I*, 218 B.R. at 695-96 and SIPA, 15 U.S.C. §§ 78fff-2(c)(1) and 78fff-3(a)).

Claimants conceded that Hanover's conduct was fraudulent. *See Decision*, 247 B.R. at 90, 95. On this appeal, Appellants have not challenged the bankruptcy court's conclusion on this point. In fact, they acknowledge that Hanover's brokers had engaged in fraud. *See* Appellants' Brief at 59. They argue only that to the extent Hanover committed fraud it did not do so as Appellants' agent. *See* Appellants' Brief at 53-58. This Court thus accepts the bankruptcy court's factual recitations and findings with regard to Hanover's fraud and other unlawful actions. Appellants take issue, however, with the bankruptcy court's conclusions of law relating to attribution of Hanover's fraud to Adler and in turn by operation of agency principles, to Appellants.

b. *Domination or Control of the Debtor*

The bankruptcy court, applying a common law principle, determined that Hanover's actual fraudulent intent may be ascribed to Adler on the basis of the court's [*442] conclusion that Hanover dominated or controlled Adler's disposition of its (Adler's) property. *See Pirrone v. Toboroff (In re Vaniman Int'l, Inc.)*, 22 B.R. 166, 182-85 (Bankr. E.D.N.Y. 1982); [**82] *Langan v. First Trust and Deposit Co.*, 293 N.Y. 604, 59 N.E.2d 424 (N.Y. 1944); *see also* 5 *Lawrence P. King, Collier on Bankruptcy* P 548.04[1], at 548-24 (15th ed. Rev. 2000) (hereinafter "*Collier*") ("When the transferee or obligee is in a position to dominate or control the debtor's disposition of his property, however, his intent to hinder, delay, or defraud creditors may be imputed to the debtor so as to render the transfer fraudulent within section 548(a)(1)(A) regardless of the actual purpose of the debtor transferor.").

In support of its domination or control determination, the court relied, first, on the fact of the electronic connections between Hanover and Adler through a direct computer link installed by Adler when Hanover joined its roster of introducing brokers in October 1994. *See Decision*, 247 B.R. at 90. This system provided Hanover direct access to its customers' accounts at Adler, and physically enabled it to manage what purchases and sales were booked to its customers, and to have exclusive knowledge of which trades were legitimate.

As described by Judge Garrity, Hanover brokers obtained orders from their customers [**83] and wrote uptrade tickets containing information that Hanover's trading desk entered into its computer and automatically transmitted to Adler for clearing and settlement. *See id.* With regard to transactions involving House Stocks, the entry of the trading ticket information was automatic. *See id.* The process for entries on Adler's books as to securities other than the House Stocks depended on the exchange on which the security was listed. For shares registered on the New York or the American Stock Exchanges, Hanover's trading desk obtained the market price from Adler's trading desk and then Adler proceeded to execute the transaction as Hanover instructed. *See id.* at 91. For unlisted Blue Chips traded in over-the-counter markets, Hanover itself obtained the price and then posted and executed the trade through its computers into the customers accounts at Adler. These trades were booked into the customers' accounts on the evening of the day when they occurred and appeared in Adler's computer system by the following morning. *See id.*

Thus, Judge Garrity concluded that "at a mechanical level, Hanover controlled what Adler knew about its customers' trading." [**84] *Id.* Moreover, "Adler did not select the Hanover trades which were entered on its books and did not monitor the trades on a real-time basis…. Unless Adler took affirmative steps otherwise, the trades Hanover unilaterally input automatically settled." *Id.* By these means, Hanover managed not only to perpetrate the massive frauds evidenced here, but to conceal from Hanover the full scope of its unlawful activities and true financial condition.

The Trustee argued, and the bankruptcy court concurred, that Hanover's domination or control of Adler was inherent in the electronic clearing process so described, and that it was the automatic posting of securities purchases and sales in Adler's trading system, books and records that enabled Hanover during the Final Week to control the process that culminated in the entries of the disputed cash credits and Blue Chip securities purchases into Appellants' accounts. *See id.* Accordingly, the bankruptcy court ruled that, although the fraudulent intent to which § 548(a)(1)(A) refers is that of the debtor, the intent of a transferee of the debtor's property may be imputed when the transferee is in a position [*443] to dominate or control the debtor's [**85] disposition of its property. *See id.* (citing *Ensminger I*, 218 B.R. at 704; 5 *Collier* P 548.04[1]).

Appellants challenge the bankruptcy court's application of the intent imputation doctrine on several grounds. They contend that the exception is narrowly limited to cases in which the transferee's domination or control over the debtor's management of its business decisions is complete, as when the debtor is essentially the transferee's alter ego, a wholly-owned entity or a controlled corporate subsidiary. *See* Appellants' Brief at 65-67. In support of this argument, Appellants cite precedents where the doctrine was applied. These cases involve control of a debtor by transferee principals, large shareholders, executive officers, directors and insiders or by another corporation, whose dominance of the debtor, by virtue of their relationship, is so extensive that the separate identity of the transferor debtor may be disregarded and the debtor may be deemed as transacting the business of the controlling person or entity rather than its own. *See Gartner v. Snyder*, 607 F.2d 582, 586 (2d Cir. 1979); *In re Cushman Bakery*, 526 F.2d 23, 31 (1st Cir. 1976); [**86] *In re Southern Land Title Corp,*, 474 F.2d 1033, 1038-39 (5th Cir. 1973); *Armstrong v. United Bank of Bismarck (In re Bob's Sea Ray Boats*), 144 B.R. 451, 459 (Bankr. D.N.D. 1992); *Freeling v. Nielson (In re F&C Services, Inc.)*, 44 B.R. 863, 868 (Bankr. S.D. Fla. 1984); *Vaniman Int'l*, 22 B.R. 166.

Appellants maintain on appeal that there is no evidence that Hanover was Adler's insider or alter ego, or that the two firms formed parts of a single entity sufficient to establish Hanover's control. They stress that Adler made business decisions entirely independently of Hanover through separate directors, officers, shareholders and employees. *See* Appellants' Brief at 66. Moreover, Appellants assert that Adler, acting for its own advantage, entered into the Clearing Agreement independently, accepted Hanover's trades for clearance and settlement, monitored those trades and retained the right unilaterally to end its computer links with Hanover, but chose not to terminate its relationship with Hanover despite its knowledge of Hanover's financial condition and fraudulent practices. *See id.* Appellants further argue that [**87] under the domination or control doctrine the fraudulent intent is imputed to the debtor from the dominating or controlling transferee, and that in this case the relevant transferees were Appellants, rather than Hanover. Finally, Appellants assert that a mere contractual right to cause an entirely independent debtor to transfer property does not give rise to domination or control for the purposes of the rule. *See id.* at 66-67.

The central consideration under § 548(a)(1)(A) is not what form of ownership or institutional links govern the relationship between the transferee and the debtor. Rather, examining the standard formulation of the principle, the relevant inquiry more narrowly reduces to three elements. First is that the controlling *transferee* possesses the requisite intent to hinder, delay or defraud the debtor's creditors. Second, the transferee "must be in a position to dominate or control". And third, the pertinent domination and control relates to "the debtor's disposition of his property". *See* 5 *Collier* P 548.04[1], at 548-24.

(i) *Transferee's Intent*

Appellants claim error in the bankruptcy court's application of the domination or control [**88] doctrine as it related to the relevant transferees and beneficiaries of the obligations the Trustee seeks to avoid, and through whom the fraudulent [*444] intent must derive. Appellants assert that they, and not Hanover, were the transferees. Accordingly, they maintain that because there is no evidence demonstrating that Appellants had any intent to hinder, delay or defraud Adler or its creditors, the doctrine is inapplicable in this case. This issue raises a fundamental disagreement between the parties and the bankruptcy court.

The bankruptcy court's analysis of the domination or control doctrine proceeds on the premise that the pertinent transferee in this case is Hanover, although the court does not specify which "property" of Adler's Hanover as transferee was in a position to dominate or control -- for example, whether it was Adler's own funds which Adler advanced as loans to Hanover, or customer property Adler held in its accounts, or both. The court refers only to Hanover's domination or control over Adler by virtue of Hanover's ability to effectuate trades independently of Adler and to book them automatically into the customers' accounts. *See Decision*, 247 B.R. at 90-94. [**89]

Nonetheless, the bankruptcy court endeavors to respond to Appellants' argument by adding a third element to the requirements mentioned above that the Trustee must establish in order to prevail on his avoidance claim under § 548(a)(1)(A): that Claimants, as the ultimate beneficiaries of the trades sought to be avoided, are responsible under applicable law for Hanover's fraudulent acts. *See id.* at 86. The court then, applying agency law principles, concluded that in booking the Challenged Trades on their behalf Hanover acted as the Claimants' agent and within the scope of the authorized agency. *See id.* at 95-101. As a consequence, to satisfy the third prong of the § 548(a)(1)(A) test it articulated, the court attributed Hanover's fraudulent intent to the Claimants. *See id.*

On appeal, the Trustee takes issue with this aspect of the bankruptcy court's ruling. Contending that while Appellants' responsibility is germane to the Trustee's common law defenses, it is superfluous to the application of § 548(a)(1)(A). *See* Trustee's Brief at 39.

This Court finds some confusion and circularity in the parties' arguments concerning this issue, as well [**90] as an ambiguity in the bankruptcy court's corresponding determination. The plain language of § 548(a)(1)(A) itself contains no reference to any requisite intent on the part of a transferee, to this extent supporting the Trustee's position. The provision explicitly mentions three parties as having operative roles in the application of the trustee's avoidance powers: (1) the trustee, who is authorized to avoid a covered transfer of an interest in property or an obligation incurred by the debtor; (2) the debtor, who, while possessing the requisite actual intent to defraud, hinder or delay, transfers the property or incurs the obligation; and (3) the entity or creditor to which the debtor was or became indebted by reason of the transfer or obligation. *See* 11 U.S.C. § 548(a)(1)(A).

There is no reference at all in the text to any requirement implicating the debtor's transferee. The only inquiry concerning actual intent that matters is that of the *debtor*: whether the debtor causing the transfer or incurring the obligation intended to hinder, delay or defraud its creditor. *See, e.g., Rubin Bros. Footwear, Inc. v. Chemical Bank (In re Rubin Bros. Footwear Inc.)*, 119 B.R. 416, 423. [**91] (Bankr. S.D.N.Y. 1990) ("For the purposes of [§ 548(a)(1)(A)], plaintiff must show fraudulent intent on the part of the transferor, rather than on the part of the transferee."); *McColley v. Rosenberg (In re Candor* [*445] *Diamond Corp.)*, 76 B.R. 342, 349 n. 4 (Bankr. S.D.N.Y. 1987) (referring to transferee's intent as irrelevant).

The circularity enters the picture here because where, as in this case, the debtor itself is presumed not to have possessed the actual intent to defraud, the requirement of the statute cannot be satisfied unless the fraudulent intent devolves upon the debtor through imputation of the misconduct of another person. The whole purpose of the domination or control doctrine so exhaustively treated by the parties and the bankruptcy court is to address precisely this situation. Under the domination or control rule, the requisite intent derives from a *transferee* who is in the position to dominate or control the debtor's disposition of his property, a circumstance that § 548(a)(1)(A) anticipates by its provision that the fraudulent conveyance by the debtor may be voluntary or *involuntary*. In the typical case, the controlling transferee stands [**92] either to gain directly or to confer benefits upon others by securing possession of the property and keeping it out of the reach of creditors.

The conceptual thicket in which the parties here become entangled arises because, for the purposes of applying the domination or control exception, they lose sight of who is the appropriate transferee given the multiple relationships and transactions particular to this case. In fact, largely on account of the assumption underlying the third criterion the bankruptcy court identified as necessary to satisfy the requirements of § 548(a)(1)(A) -- imputation of fraudulent intent to Appellants -- the parties' arguments actually shift the focus of the transferee inquiry from Hanover, as the perpetrator of the fraud, to Appellants, as its purported beneficiaries. As stated above, the bankruptcy court, for the purposes of the second element of the test it applied to satisfy § 548(a)(1)(A) -- Hanover's domination or control of Adler's disposition of its property -- properly assumed that Hanover was the transferee. The premise underlying the court's third criterion, however, is that Appellants, as they themselves contend, are the transferees because, [**93] absent Adler's cancellation of the Challenged Trades, they would stand to gain delivery of the Blue Chips through their Adler accounts.

This difficulty arises largely by reason of the trilateral relationship that existed here among Appellants, Hanover as their introducing broker, and Adler as Hanover's clearing house, as well as two-step trades involving a sale of House Stocks and simultaneous purchase of Blue Chips. These circumstances present some unique variables that alter the position of the respective parties as transferor or transferee depending upon the progression of clearing and settlement of the different aspects of the securities trades through the multiple stages of the process.

As described by the bankruptcy court, though not expressly stated in the portion of the analysis concerning Hanover's domination or control of Adler, in the three-way relationship which bound the parties, Hanover maintained the primary contacts with the customer. Adler held the customers' cash and securities. *See Decision*, 247 B.R. at 67. Adler's clearing services for Hanover were rendered on a fully disclosed basis: the customers Hanover introduced knew that Adler held their [**94] property in their accounts and received trade confirmations and account statements directly from Adler. *See id.*

Hanover also maintained various proprietary or trading accounts with Adler, which held the securities and cash belonging to Hanover and its customers in Adler's bank accounts. *See id.* Thus, Adler cleared and settled all transactions between Hanover's proprietary accounts

[*446] and Hanover's customer's within Adler's own internal system. Under this arrangement, as the bankruptcy court found, "no transaction among Hanover customers or between a Hanover customer and the Street took place without Hanover's proprietary accounts acting as the 'middle man'." *Id.* at 68. To cite an example used by the bankruptcy court, if Hanover customer A were selling House Stocks and Hanover customer B was the ultimate buyer of those House Stocks, Hanover itself, through its proprietary accounts, would purchase the stock from A and sell it to B. *See id.*

This description of the process may shed light on the dispute at hand relating to the appropriate transferee. For when Hanover acquired large quantities of House Stocks from its customers without assets in its proprietary [**95] accounts sufficient to pay for them, such as it did during the Final Week, and Adler in turn -- unaware of Hanover's true financial condition, which Hanover concealed from Adler -- cleared and settled those trades, Adler was compelled to transfer funds of its own as loan advances into Hanover's proprietary accounts. Adler thus was made to incur obligations to pay for Hanover's purchases. In other words, before the customers could sell their House Stocks to Hanover and expect credits to their accounts corresponding to the proceeds of those sales, Hanover had to be in a financial position to purchase. For Hanover to purchase House Stocks from customers in such transactions, Hanover stood in another respect as the "middle man" to which Judge Garrity referred. *See id.*

Hanover was first a transferee of property of Adler's or held in Adler's estate that was conveyed into Hanover's proprietary account, from which the assets were subsequently transferred to the accounts of the customers in the form of cash, credits or securities. At that later point, the customers theoretically became Hanover's transferees, although presumably the property they received, because Hanover was insolvent, [**96] actually derived from Adler's assets. With regard to the particular trades here at issue, Adler credited cash to Appellants' accounts, which was drawn from the balances in Hanover's proprietary accounts already maintained by Adler's loan transfers, and became obligated to deliver the Blue Chips to Appellants upon settlement. As regards this later stage of the transaction, were it executed, the customers would become Adler's transferees.

In their arguments before the bankruptcy court, the Claimants acknowledged this arrangement. They argued that Adler kept Hanover in business for several weeks by financing Hanover's House Stock purchases. *See Decision*, 247 B.R. at 84. According to Judge Garrity, the Claimants contended that "Adler paid for the Challenged Trades by increasing Hanover's outstanding debit to it by debiting Hanover's then-negative proprietary account, and delivering the cash to the Claimants by making credits to their accounts." *Id.*

This argument underscores the point this Court considers crucial to the resolution of the issue at hand. First, under the arrangements of the trades in question and the tripartite relationship that existed among the parties, [**97] and as a consequence of the events set in motion by Hanover in connection with the Challenged Trades of the Final Week, Adler was the initial transferor of its property to Hanover and incurred obligations occasioned by the actions of Hanover as transferee of that property in the first instance.

Second, even if later in the sequence of the transaction Appellants as customers became transferees and beneficiaries of the trades entitled to delivery either of the [*447] proceeds of their sales or of the Blue Chips, for the purposes of the fraudulent intent requirement of § 548(a)(1)(A), their subsequent status as secondary transferees would be irrelevant. What matters in this connection is solely what is subsumed in the bankruptcy court's conclusions: that at the moment Hanover purportedly exercised domination or control over Adler's property in connection with Hanover's House Stocks purchases from Appellants, it caused a transfer of Adler property as well as the incurrence of obligations by Adler at Hanover's behest initially for Hanover's account. Hanover thus became the first transferee.

Third, Hanover, for its own accounts as well as to advance the interests of its officers and brokers [**98] and their friends, relatives and favored customers, sought to reap substantial benefits and promote Hanover's own ends by causing Adler to transfer funds and/or record credits from Hanover's fraudulent trades into the particular customers' accounts. That was the whole point of the scheme. Consequently, this Court finds that for the purposes of the domination or control principle, the bankruptcy court correctly treated Hanover as the transferee.

(ii) *Position to Control*

As emerges from the cases, the conceptual foundation for the domination or control doctrine may rest on several principles that justify the imputation of the transferee's fraudulent intent to the debtor. First, in the typical case the person or entity exercising control over the disposition of the debtor's property stands in a position to do so by reason of a relationship of ownership, executive office or other insider role. *See, e.g., Bob's Sea Ray Boats*, 144 B.R. at 459 ("This situation normally arises… where the transferee is the Debtor's sole or dominant shareholder…. The cases are careful to point out that vicarious intent is an extreme situation that is dependent upon nearly total control [**99] of a debtor by a transferee.") (citations omitted); *F&C Servs.*, 44 B.R. 863; *Vaniman Int'l*, 22 B.R. 166; *Langan*, 293 N.Y. 604, 59 N.E.2d 424; 5 *Collier* P 548.04[2][b], at 548-27-28 and cases cited therein.

The unique status the controlling person holds creates the basis for the exercise of authority that then forms the predicate for the attribution of intent. That position establishes an overlapping of prerogatives that enables that person to assume identity as an alter ego. In some instances the controlling person is empowered to engage in the business affairs of both the transferor and transferee and to effectuate property transfers from one to the other, and in other cases to designate himself or another party as transferee. In these circumstances, some connecting link exists between the transferor-debtor and the controlling transferee. One and the same person or entity usually stands at both ends of the transaction, effectively rendering one party as but an extension of the other. The shared affiliate then serves as the conduit by which the fraud is both committed and concurrently transmitted to the controlled [**100] debtor.

In other words, by virtue of the common relationship to both sides of the disposition, the wrongful intent embodied in the controlling transferee may be presumed to flow on to the debtor-transferor as the property passes, for all practical purposes, from one hand to the other of the same person, ending with the intended transferee. The property disposition is effectuated in a manner that is other than strictly arms length, either with the knowledge, consent or acquiescence of the debtor. The controlled person or entity, from its subordinate position, lacks the independent [*448] means to reverse the exercise of dominion over it. Accordingly, the domination is thus a product of the relationship and does not inhere in the controlling person's fraudulent intent itself, or derive from the actions or means employed to cause a disposition of the debtor's property. *See, e.g., F&C Serv.* 44 B.R. at 868.

A second theory, not explicitly articulated in the cases, may be grounded on application of agency principles. The controlling person, standing in the position of either principal or agent on either side of the transaction, may be presumed to act with actual or apparent authority [**101] to effectuate the disposition of the relevant property from the debtor on behalf of and for the benefit of the transferee.

Third, in some cases the controlling person is considered to stand in a fiduciary capacity or hold a position of trust in the transferor entity. *See Limperis v. Kolacny*, 36 B.R. 626, 631 (Bankr. N.D. Ill. 1984). Fourth, the rule imputes the fraudulent intent in order to recognize and discourage the misuse of the corporate form and insider status as instruments to commit fraud by means of transferring property between affiliated entities. *See F&C Serv.*, 44 B.R. at 868 (citing *United States v. Benjamin*, 328 F.2d 854, 863 (2d Cir. 1964)); *In re Himoff Enters., Ltd.*, 1979 Bankr. LEXIS 696, 22 Collier Bankr. Cas. (MB) 36, 52 (Bankr. S.D.N.Y. 1979). So framed, the doctrine may be regarded as analogous to or an extension of the rules that treat evidence of a transfer of debtor's property between close family relations or other agents or insiders of the debtor as a badge of fraud. *See* 5 *Collier* P 548.04[2][b], at 548-27-28.

Whatever its conceptual underpinnings, at the heart of the doctrine is a [**102] culpable act committed by the debtor, actively or passively, for the purpose of keeping particular assets out of the reach of creditors. Insofar as the imputation rule applies to intentional acts. it serves various behavioral and financial purposes: to deter and penalize the debtor for harmful conduct, to prevent unjust enrichment to the debtor or the chosen transferee, and to make the injured creditors whole to the extent of the improper transfer. As considered below this Court concludes that extending the rule to the circumstances of this case satisfied none of the principled grounds justifying the doctrine.

(iii) *Disposition of Debtor's Property*

The bankruptcy court found that through the mechanical means at its disposal, Hanover was able to effectuate transfers of Adler's property and to create obligations on Adler's part flowing to particular customers. That Appellants here seek to reap the benefits of those transactions attests to the reality of Hanover's access to Adler's property, and to its ability, at least "at a mechanical level" to affect its disposition. *Decision*, 247 B.R. at 90.

Nonetheless, this Court is not persuaded that the domination or control [**103] doctrine applies to the unique circumstances this case presents. Nor has it seen sufficient precedent or authority to support the bankruptcy court's determination. The bankruptcy court reasoned that nothing in the cases which have invoked the rule suggests that the controlling person must be an insider able to exercise total control over the debtor. By the same token, nothing in the case law is sufficiently analogous to indicate clearly that the doctrine is apposite in this case.

Here, none of the doctrinal circumstances that justify imputation of fraudulent intent to the debtor prevails. Adler and Hanover were independent, unaffiliated companies. Their open legal relationship set forth in the Clearing Agreement was arms-length, and their interests potentially hostile. The parties shared no [*449] continuous institutional channel through which the transference of fraudulent intent simultaneous with a disposition of property could be effected. Nor could Hanover have been regarded as Adler's authorized agent in effectuating the property transfers at issue. In fact, as is central to the Trustee's theory, Hanover served as Appellants' agent in booking the Challenged Traders and deceiving Adler, [**104] and could not simultaneously have acted as Adler's principal directing Adler knowingly to defraud itself.

None of the circumstances the bankruptcy court relies upon in applying the domination or control principle accords aptly with the conceptual framework underlying the doctrine. Extending the rule here leaves the fit somewhat tortured, showing the markings of a procrustean stretch. The mechanical access that computer connections afforded Hanover to execute securities trades and corresponding transfers of Adler's property do not create the authoritative link in one and the same person to both sides of the transaction by which fraudulent intent may be conveyed in the process of effectuating a property transfer. Those connections enabled nothing more than unilateral acts on Hanover's part that, to the extent they were designed specifically to defraud Adler, could not have been performed with any aura of authority.

Neither does the circumstance that Hanover brokers took steps to conceal their purpose from Adler constitute a measure of control. Semblance and secrecy is the way of all theft. If false appearances created by the wrongdoer served as the standard, every common thief could [**105] be deemed to be in a position to control the disposition of the victim's property. In the case of bankruptcies involving banks and securities brokers that have hundreds of thousands of customers, every client presumably could be regarded as being in a position to dominate or control the debtor merely by making withdrawals from his accounts upon receiving pre-petition bad news. In fact, in the application of the domination or control doctrine, by reason of the overlapping relationship inherent in the position of the controlling person and the debtor, maintaining strict secrecy of the transfer as between the transferor and the transferee is virtually impossible. Moreover, to the extent the debtor claims to have been unaware of the fraudulent conveyances, as Adler does here, the purpose of deterring, penalizing and preventing unjust enrichment of the debtor's known transferee would not be served in relation to the conduct of the debtor.

Neither the Trustee nor the bankruptcy court cites controlling or even plausible precedent on point to support extension of the domination or control rule to circumstances comparable to those raised by this appeal. In concluding its analysis of the applicability [**106] of § 548(a)(1)(A), the bankruptcy court does cite a case involving a scheme almost identical to the one Hanover devised, under a fact-pattern of misconduct not nearly as extreme as that evident here, where the transactions at issue were found to be fraudulent transfers and invalidated under § 548(a)(1)(A). *See SEC v. S.J. Salmon & Co.*, 1973 U.S. Dist. LEXIS 15606, 72 Civ. 560, slip. op. (S.D.N.Y. Aug. 8, 1973) ("Salmon I"); *SEC v. S.J. Salmon & Co.*, 72 Civ. 560, slip. op. (S.D.N.Y. Feb. 5, 1974) ("Salmon II").

Salmon, the debtor in those cases, was a broker-dealer which, like Hanover, was the underwriter and principal market maker for certain house stocks which constituted the debtor's primary assets for net capital purposes. Under examination by the market regulator because it faced a large net capital deficiency, Salmon knew that "the liquidation of its business was both inevitable and imminent and that the quoted values of [its house stocks] would dip [*450] sharply with its withdrawal as a market maker for those securities." *Salmon I*, at 9-10. The regulators concluded, and so informed Salmon's principals, that there was only a minimal market for the house stocks at any market value, that the firm's [**107] capital position was illiquid, and that the firm was in violation of the regulators' net capital rules.

In another striking resemblance to the events reenacted by Hanover, on the last day Salmon was open for business, it purported to purchase for the firm's own proprietary account certain securities from selected customers at the prices it had been quoting as a market-maker. Salmon recorded cash credit balances on the customers' accounts in executing those trades. On the same day, Salmon also purported to cancel certain sales of its house stocks to customers. The purpose of the transaction was to invest Salmon's favored customers with a cash claim that, in Salmon's liquidation proceedings, would qualify for preferred status for payment by SIPC.

On this record, the *Salmon* court concluded that there was "no room for doubting that the . . . transactions were intended by the debtor to place favored customers in a position so that instead of finding themselves possessed of securities that would shortly be severely depressed in value, they would appear to have cash credit balances at preliquidation prices and thus be entitled to the protection afforded by SIPA." *Id.* at 14. The [**108] court therefore determined that Salmon's design was a deliberate attempt to defraud SIPC, and that the trades could be avoided by the bankruptcy trustee as having been made with actual intent to hinder, delay or defraud existing or future creditors within the meaning of § 67(d)(2) of the former Bankruptcy Act. [24]

In *Salmon*, the debtor exhibited actual intent to defraud its creditors, whereas here, because Adler itself did not intend to defraud its creditors, Adler's transfers to Hanover or to Appellants cannot be found to be actual fraudulent conveyances unless Hanover's intent is imputed to Adler. On this point, the bankruptcy court, relying on the domination or control principle to ascribe the necessary intent, noted that the distinction based on the existence of an intervening clearing [**109] broker as debtor in this case should not matter to the outcome.

This Court, however, is not persuaded that sufficiently clear, settled precedent exists to support such an extension of the domination or control doctrine here. In fact, in one case where the domination or control principle was sought to be expanded to a narrow financial relationship between otherwise independent parties based on a property interest secured by mortgages, the First Circuit affirmed a reversal of the bankruptcy court's ruling that the doctrine applied. *See In re Cushman Bakery*, 526 F.2d 23 (1st Cir. 1976). [25]

[**110] [*451] This Court does not construe the domination or control doctrine to permit the exercise of a given limited power employed for wrongful or unlawful purposes, in and of itself, to equate to domination or control over the disposition of another's property sufficient for the purposes of the rule. Accordingly, the Court cannot sustain the bankruptcy court's application of the Trustee's avoidance mechanism under § 548(a)(1)(A), insofar as it rests upon the courts' findings that Hanover dominated or controlled Adler's disposition of its property and that by imputation of Hanover's intent, Adler therefore intended to hinder, delay or defraud Adler's creditors or SIPC. The Court is also of the view that a further finding that Appellants are responsible for Hanover's fraudulent acts is unnecessary to satisfy the requirements of § 548(a)(1)(A).

c. *Appellants' Responsibility*

Though the Court is of the view that the Trustee, for the purposes of avoiding the Challenged Trades pursuant to § 548(a)(1)(A), is not required to prove that Appellants may be held liable for Hanover's fraudulent acts, the Court nonetheless deems consideration of Appellants' responsibility appropriate at this point. [**111] First, upon review of the evidence and the parties' arguments regarding this issue, the Court is satisfied that in the event such a requirement were determined to be an element of the applicable test under § 548(a)(1)(A), the record here is sufficient to meet the standard, and the bankruptcy court's factual findings and conclusions of law in this regard are sustainable.

Second, Appellants continue to insist strenuously upon their innocence in defense to the bankruptcy court's determination that they be held responsible for Hanover's frauds. The short answer to Appellants'

[24] Section 67(d)(2) of the Bankruptcy Act of 1898 is the predecessor of § 548(a)(1)(A) of the 1978 Bankruptcy Code. *See Ensminger I*, 218 B.R. at 707; 5 *Collier* P 548.LH [1], at 548-89.

[25] In *Cushman Bakery* the debtor corporation, experiencing severe financial difficulties and without other sources of credit to stay in business, obtained a loan from its longtime supplier at terms very favorable to the lender. The loan was secured by second mortgages on the debtor's real and personal property used for its plants. The First Circuit found that while the terms of the loan may have been disproportionately favorable to the creditor, it nonetheless was an arm's length transaction negotiated by independently controlled and nonaffiliated entities. It held that evidence that the debtor was strapped for cash and that the supplier had stopped shipments before the security agreement was consummated was insufficient to satisfy the domination or control rule. The Circuit Court also found insufficient evidence of fraudulent intent on the part of either the debtor or the transferee creditor at the time the agreement was reached. *See id.*

objections has already been furnished above: insofar as Appellants' theory rests on their status as transferees, for the purposes of avoidance pursuant to § 548 the transferee's good faith or lack of it does not matter. *See* 5 *Collier* P 548.04 [1], at 548-23. The longer response, elaborated below, is that under applicable agency law principles, Appellants can be charged with Hanover's frauds to the degree Hanover served as their authorized agent in executing the Challenged Trades. The rules apply at least to the extent of entitling the Trustee to rescind the Challenged Trades, to recover for [**112] Adler's estate the property fraudulently transferred to Appellants' accounts, and/or to defeat Appellants' efforts to enforce obligations Adler incurred on account of Hanover's fraud committed on Appellants' behalf. Third, while the issue of Appellants' responsibility for their agent's fraud may not be relevant to the Trustee's avoidance claim pursuant to § 548(a)(1)(A), that fraudulent intent is relevant to the additional challenges pressed by the Trustee to invalidate the Challenged Trades under common law fraud and contract principles, a matter examined below. *See* discussion *infra* Part III.E.1.

(i) *Appellants' Theory and the Bankruptcy Court's Ruling*

In contesting the bankruptcy court's ruling holding them responsible for Hanover's fraud, Appellants advance several points. First, concerning the bankruptcy court's conclusions of law, Appellants take issue with Judge Garrity's determination that Hanover's fraudulent misrepresentations [*452] to Adler regarding the price Hanover was willing and able to pay for the House Stocks it purchased from Appellants, as well as the entries of Fake Buys and Fake Short Sales in Adler's books, could not be divorced from Hanover's purchase [**113] of Appellants' House Stocks. They thus dispute the ruling that Hanover's fraudulent acts were committed within the scope of its agency on behalf of Appellants. [26] *See* Appellants' Brief at 53; *Decision*, 247 B.R. at 96.

Under Appellants' theory, because Appellants did not and could not control actions Hanover took as market-maker/dealer, at the time Hanover made its fraudulent misrepresentations to Adler about the inflated price of the House Stocks and engaged in related misconduct, Hanover functioned not as broker/agent for Appellants, but as market-maker and dealer/principal trading for its own account. Thus, Appellants argue, the scope of authority they granted, as well as the representations Hanover made acting as their agent, extended solely to placing and executing the orders to sell their [**114] House Stocks at the quoted market price and, pertaining to the Blue Chips, to purchase them at market price.

By their formulation, the agency Appellants granted Hanover falls within the bounds of the ordinary broker-customer relationship that is generally limited to the completion of the transaction. *See Robinson v. Merrill Lynch, Pierce Fenner & Smith, Inc.*, 337 F. Supp. 107, 111 (N.D. Ala. 1971), *aff'd*, 453 F.2d 417 (5th Cir. 1972). On this basis, Appellants assert that Hanover's representations to Adler on their behalf had nothing to do with Hanover's ability to pay for the trades it executed as Appellants' agent and "contained no falsehood or deception." Appellants' Brief at 53.

Next, they contend that, as a matter of general policy, making innocent securities customers vicariously liable for their brokers' fraudulent market manipulations simply because the brokers executed their trades could expose customers to actions for open-ended recovery by any defrauded investor who would sue not only the dealer but any customers who benefitted incidentally from the fraud's effect on the market value of their stocks. *See id.* at 52.

The bankruptcy [**115] court found no merit in Appellants' effort to distinguish Hanover's role as securities market maker/principal trading for its own account and as broker/agent acting on behalf of Appellants. The court determined that on a given transaction, a broker can act simultaneously in a dual capacity, as dealer/principal buying and selling for its own account and also as broker executing its customers' transactions. *See Decision*, 247 B.R. at 96 (citing *Ensminger I*, 218 B.R. at 705); *see also In re Merrill Lynch Sec. Litig.*, 911 F. Supp. 754, 760 (D.N.J. 1995), *rev'd on other grounds*, 135 F.3d 266 (3d Cir. 1998). On this basis, Judge Garrity concluded: "Indeed, if the Claimants did not authorize Hanover, as their agent, to agree to the prices that Hanover, as buyer, offered to pay for their House Stocks, there could not be any securities transactions at all, and the Claimants would have no claim herein." *Id.*

This Court concurs with Judge Garrity's reasoning and adopts his conclusion on this point. Under New York's Statute of Frauds in effect at the time of the transactions here in question, absent incorporation of a price [**116]

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[26] The bankruptcy court found evidence that certain Claimants had satisfied their burden of demonstrating that they authorized their Challenged Trades. *See Decision*, 247 B.R. at 82.

on the written and signed [*453] terms of a securities trade, a valid contract enforceable against Adler could not have formed. *See* N.Y.U.C.C. § 8-319; *Ensminger II*, 218 B.R. at 23. Accordingly, Hanover could not have fully executed the Challenged Trades Appellants concede they authorized Hanover to carry out on their behalf without an agreement reflecting the sale price Appellants would accept and Hanover would pay for Appellants' House Stocks. Incident to carrying out the agency is the power to effectuate the transaction as contemplated. In other words, when Hanover executed the orders Appellants authorized and transmitted them to Adler, the services Hanover performed at Appellants' behest and as their agent necessarily encompassed the authority to agree upon a price and to communicate it and other trade ticket information to Adler. *See Decision*, 247 B.R. at 96.

However, as the bankruptcy court found undisputed here, during the Final Week, other than the market Hanover itself created, there was no open market for the House Stocks at the manipulated and artificial prices Hanover quoted to Appellants and other customers for its purchases of House Stocks. [**117] Hanover's price inflation included fictitious purchases and sales that were intended to defraud Adler and its creditors. *See id.* at 97. Despite Hanover's knowledge that its quoted prices were fictitious, the Hanover brokers, acting as Appellants' agents, proceeded to enter the trades into Appellants' accounts at Adler. In so doing they were conscious also that Hanover did not have the ability to pay Adler for the proceeds of the sales that Hanover was debiting out of its proprietary account and crediting into Appellants' accounts, but intending that ultimately Adler would be obligated to make good on the transactions since Hanover could not. *See id.* Appellants cannot assert entitlement to the full value of their House Stocks Sales, and to the application of those proceeds to the Blue Chips securities whose delivery they demand into their accounts, while denying Hanover's authority as their agent to effectuate the transactions on the very terms that would have yielded the particular value Appellants seek to enforce. A significant portion of that value is attributable to Hanover's unlawful price manipulation.

(ii) *Agency Principles*

Under basic precepts of agency [**118] law, Appellants may be charged with the knowledge and/or fraudulent intent of Hanover acting as their broker within the scope of its authority to execute the Challenge Trades on Appellants' behalf, even absent Appellants' knowledge of the fraud or lack of their own fraudulent intent. *See Curtis, Collins & Holbrook v. United States*, 262 U.S. 215, 223, 67 L. Ed. 956, 43 S. Ct. 570 (1923) ("The general rule is that a principal is charged with the knowledge of the agent acquired by the agent in the course of the principal's business."); *see also* Restatement (Second) of Agency §§ 259, 263, 272, 298 (1958).

These rules find particular application where the principal seeks to enforce a transaction so as to avail himself of the fruits of the agent's fraud, even if the fraud committed falls outside the scope of the agent's authority. *See Fineberg v. Stone (In re Brainard Hotel Co.)*, 75 F.2d 481, 482 (2d Cir. 1935); *Harriss v. Tams*, 258 N.Y. 229, 179 N.E. 476, 479 (N.Y. 1932) ("This court has held that principals, who after offer to rescind, retain or demand the fruits of a contract obtained by unauthorized representations of an agent 'stand [**119] in the same position as if they had made the representation or authorized it to be made.'") (citations omitted); *Angerosa v. White Co.*, 248 A.D. 425, 290 N.Y.S. 204 (N.Y. App. Div. 4th Dep't 1936), *aff'd*, 275 N.Y. 524, 11 N.E.2d 325 [*454] (N.Y. 1937) ("A principal who gives his agent authority to solicit a sale and accepts the fruits of his efforts will be held responsible for the fraudulent as well as the fair means by which the contract was obtained, if such instrumentalities are in line with the accomplishment of the object of the agency."); *see also* Restatement (Second) of Agency § 263 ("Unless he has changed his position, a principal whose servant or other agent has fraudulently acquired property for him, holds it subject to the interest of the defrauded person.) [27]

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[27] The Restatement elaborates the principle of § 263 with two illustrations that are particularly apt to the issues now before this Court.

> 1. A, agent for P, steals Chattels from T, sells them, and places the proceeds in his principal's account. P is subject to liability to T for the proceeds.
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> 2. A, having no power to bind P to the transaction, borrows from T, purporting to borrow on P's account. He places the money so borrowed on P's account from which he had previously embezzled, and draws upon this account to pay workman employed by P. P is subject to liability to T, since this money has been used for his benefit.

Restatement (Second) of Agency § 263, illus., 1 and 2.

The knowledge of the agent acting within the agency power entrusted may be imputed to the principal, and the principal's liability is affected by the agent's knowledge for the purposes of enabling a defrauded party to rescind a transaction procured through an agent's fraud, even if the principal did not authorize the agent's fraud. *See Russell v. Prudential Ins. Co.*, 176 N.Y. 178, 68 N.E. 252, 255 (N.Y. 1903) ("The rule is, that knowledge of the agent is the knowledge of the principal."); *Harriss*, 179 N.E. at 479; *see also Brainard Hotel*, 75 F.2d at 482 ("In depositing the money [the defrauding employee] acted as the hotel's agent, and the hotel had notice of the theft because he knew it himself."); *Willcox v. Goess*, 92 F.2d 8, 11 (2d Cir. 1937) ("If the principal must avail himself of a transaction entered into by the agent on his behalf, the guilty agent's knowledge will be imputed to him."); *Cathay Pacific Airways, Ltd. v. Fly And See Travel, Inc.*, 3F. Supp. 2d 443, 445 (S.D.N.Y. 1998) ("Under New York agency law, the principal may not accept the fruits of the agent's fraud and then attempt to divorce himself [**121] from the agent by repudiating the agent and his knowledge."); *Angerosa*, 248 A.D. 425, 290 N.Y.S. 204; *Reynolds v. Snow*, 10 A.D.2d 101, 197 N.Y.S.2d 590, 598 (N.Y. App. Div. 1st Dept. 1960), *aff'd*, 8 N.Y.2d 899, 204 N.Y.S.2d 146, 168 N.E.2d 822 (1960); *Abrams v. Forman*, 22 A.D.2d 824, 255 N.Y.S.2d 62 (N.Y. App. Div. 2d Dept 1964); *Zanoni v. 855 Holding Co.*, 96 A.D.2d 860, 465 N.Y.S.2d 763 (N.Y. App. Div. 2d Dep't 1983), *aff'd* 62 N.Y.2d 963, 468 N.E.2d 296, 479 N.Y.S.2d 341 (N.Y. 1984); Restatement (Second) of Agency P 272 cmt. [28]

[**122] [*455] Here, according to the bankruptcy court's factual findings, at the time Hanover entered the Challenged Trades into Appellants' accounts, the brokers knew that (1) Hanover's posted prices were fraudulently inflated by Hanover's manipulation through the Fake Sales and Fake Buys and other unlawful conduct; (2) there was no market for the House Stocks at the prices at which Hanover "purchased" them from Appellants; (3) Hanover was insolvent; (4) Hanover's proprietary account had no real cash with which to pay for Hanover's "purchase" of Appellants' House Stocks because any "proceeds" posted to the proprietary account derived from fictitious sales booked to create the appearance of a cash balance without expectation of receipt of actual funds from the fraudulent trades; and (5) Hanover had no ability and lacked intention to pay for its purchase of Appellants' House Stocks, and expected that ultimately the obligation to pay would fall upon Adler.

Hanover not only had knowledge of these circumstances, but this very knowledge and the actions it carried out in furtherance of it constituted an affirmative component of its actual intent to defraud Adler and its creditors. In other words, given [**123] the state of Hanover's knowledge about its activities and true financial condition, as well as Hanover's representations and omissions to Adler, Hanover was aware that a consequence of its actions would be to defraud Adler. Hanover's purchase of Appellants' House Stocks, which Appellants assert they authorized their brokers to sell, is wrapped into Hanover's frauds and, as more fully discussed below, cannot be separated from that related misconduct. To this extent, the fraudulent acts Hanover committed fell within the scope of its agency power. On this basis, Hanover's knowledge and associated fraudulent intent may be imputed to Appellants for the purposes of supporting the Trustee's rescission or avoidance of the Challenged Trades under common law fraud and illegality principles, as well as

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[28] The rule these cases stand for is reflected in several provisions of the Restatement (Second) of Agency. "The principal is affected by the agent's knowledge whenever the knowledge is of importance in the act which the agent is authorized to perform." Restatement (Second) of Agency § 272 cmt. a (1958). The agent's knowledge may be of importance where: "1. an agent makes a contract for the principal or acts in the execution of a contract…4. agent acquires property for the principal." *Id.* In related provisions the Restatement also incorporates the common law doctrine that "The other party to a contract made by an agent on behalf of a disclosed or partially disclosed principal has all the defenses which he would have had against the principal if the principal had made the contract under the same circumstances." *Id.* at § 298. The defenses the third party can invoke under this rule include rescission for the agent's fraud. *See id.* at § 298 cmt. a; § 259 (providing that one who is induced to enter into a contract by reliance on an agent's untrue representations is entitled to rescind the agreement); § 263 ("Unless he has changed his position, a principal whose servant or other agent has fraudulently acquired property for him, holds it subject to the interests of the defrauded person"); *id.* § 63 illus. 5 ("P authorizes A to sell, to local buyers, distant farm land. A represents to one of these buyers, T, that the land has rich sandy loam, that the country is rolling and that oil has been struck within ten miles of it. None of these statements is true. A is authorized to make the first two statements if he reasonably believes them to be true; he is not authorized to make the last statement. If A has no reason to believe them to be true, P is subject to liability for the first two statements but not to the last statement. The transaction is subject to rescission by T if any of the statements are untrue.").

under § 548(a)(1)(A) in the event it were held that Appellants' intent is a necessary element of the Trustee's action under that provision.

Appellants rely on *Deyo v. Hudson*, 225 N.Y. 602, 122 N.E. 635 (N.Y. 1919), to challenge the bankruptcy court's ruling concerning the scope of Hanover's agency. They cite the case for the proposition that the rule which imposes liability on [**124] an innocent principal for his receipt and retention of the fruits of an agent's fraud "is not unqualified". 122 N.E. at 639. In Appellants' reading, *Deyo* directly refutes the bankruptcy courts' holding that Appellants' mere retention of the benefits of their trades establishes their liability for Hanover's conduct. [29] *See* Appellants' Brief at 62.

[**125] [*456] The case is inapposite to the matter at hand, despite the general language from it Appellants rely upon. First, the actual holding of the case turned on Mitchell's lack of both real and apparent authority to give the promise he made to plaintiffs, and thus his inability to bind his employer. Second, the case addressed the brokers' retention of benefits of the alleged fraudulent conduct because plaintiffs were unable to sustain their theory of ratification, which is not at issue here. Third, the court's actual holding was that the proximate cause of the damages plaintiffs claimed was the theft by their own employee rather than the speculative trading executed by the brokerage firm.

Fourth, the case does not address the immediate issues raised by this appeal: whether a securities customer, after a fraud is uncovered, can enforce and thus retain the proceeds of a trade the broker fraudulently conducted in part for the customer's benefit, or conversely, whether the defrauded party can rescind the fraudulent transaction. The authorities earlier cited here explicitly refute Appellants' theory. In fact, the same court that decided *Deyo* later reaffirmed the rule that "a contract made [**126] on behalf of the principal may be rescinded by the other party if tainted by fraud in its inception, though the principal was himself innocent of any fraud". *Harriss*, 179 N.E. at 479. The *Harriss* court recognized that "the morality of taking advantage afterward of false statements innocently made, by insisting on retaining the advantage of a sale induced thereby, is almost as questionable as of making knowingly false statements to bring about the sale." *Id.; see also Martin v. Gotham National Bank of N.Y.*, 248 N.Y. 313, 162 N.E. 91 (N.Y. 1928). [30]

[**127] Appellants also respond that they cannot be held vicariously liable for frauds of their brokers that they did not authorize; that rescission is not contemplated as proper relief to an action under § 548(a)(1)(A); that imputed knowledge does not equate to fraudulent intent; and that to establish fraud under New York law more than knowledge of the falsity is required. *See* Appellants' Brief at 58 (citing *Flickinger v. Harold C. Brown & Co.*, 947 F.2d 595, 599 (2d Cir. 1991). Further, they contend that the proposition that a principal may not retain the benefits of a fraud derives from the doctrine of ratification. They argue that ratification does not pertain to them because they were not among the class of favored customers for whose benefit Hanover perpetrated fraud, and because Hanover's misrepresentations were not capable of being ratified by Appellants on the ground that Hanover never communicated to Adler that it was acting as Appellants' agents as regards such statements.

Appellants various objections rest on premises which have already been rejected. First, the Trustee did not seek to hold Appellants liable in damages for Hanover's frauds, but only to rescind [**128] Appellants' [*457] claims as obligations of Adler's and thus bar their enforcement. The bankruptcy court specifically limited its ruling to this basis of relief. *See Decision*, 247 B.R. at 91, 99 n.64. Second, the imputation to Appellants that is at issue here is not merely Hanover's knowledge of the

[29] In *Deyo*, plaintiffs were law partners who sued defendant stockbrokers for recovery of damages the lawyers alleged having suffered on account of speculative stock trading through defendants by Carver, one of their own attorneys, using their clients' funds. Mitchell, an employee of the brokers, undertook to inform plaintiffs promptly in the event Carver attempted any more trades through defendants' firm. Mitchell withheld from plaintiffs knowledge he had that Carver had already reopened a trading account with defendants through which he later speculated and lost additional misappropriated funds. The New York Court of Appeals held that the stockbrokers could not be held liable for their agent's fraudulent representations and that their retention of commissions earned on Carver's trading did not constitute ratification of Mitchell's conduct. *See Deyo*, 122 N.E. at 635.

[30] In *Martin*, defendant bank, because its agents were acting beyond the scope of their authority, was held not liable for damages suffered by plaintiff who was defrauded into lending money to a corporation in which two employees of defendant had an interest and whose debt to the bank was paid by the funds of which plaintiff was defrauded. The bank, however, was required to repay the proceeds it had received and applied to the employees' corporation's debt. *See* 162 N.E. at 93.

falsity of its representations but its actual fraudulent intent in connection with transactions of which both Hanover and its brokers and other favored customers, including Appellants, were the intended beneficiaries.

Third, Appellants' objections that in committing acts of fraud against Adler, Hanover did not act within the scope of the authority Appellants conferred were soundly rejected by the bankruptcy court's analysis. In fact, in connection with the Challenged Trades, Hanover acted simultaneously as agent and principal, on behalf of Appellants as authorized agent of the sales of House Stocks and Blue Chip Buys, and as principal for its own account in the purchase of those securities, rather than solely as market-maker dealer.

Fourth, concerning ratification, the Trustee agrees that the principle is not at issue here. *See* Trustee Brief at 52 n.26. While the bankruptcy [**129] court cited cases that refer to and discuss ratification, the Decision itself is not premised on the theory that Appellants satisfied the elements of ratification and thus could be held to have affirmed Hanover's fraud. *See Decision*, 247 B.R. at 98-99. Instead, the authorities the bankruptcy court refers to and relies upon are cited for the proposition that even if the Trustee could not maintain an action in damages against Appellants grounded on Hanover's fraud, the Trustee nonetheless is entitled to rescind the Challenged Trades as products of an authorized agent's fraud. *See id.*

(iii) *Hanover's Integrated Scheme*

Appellants concede that at the time Hanover executed the Challenged Trades on their behalf "Hanover's brokers were engaged in fraud to benefit themselves, their friends, their families, and certain 'favored' customers." Appellants' Brief at 59. Appellants also insist that, unlike many other Claimants, they did not count among the favored customers because, unlike those customers, as the bankruptcy court determined, Appellants produced evidence establishing that they actually authorized their Hanover brokers to execute the Challenged Trades.

Thus, [**130] Appellants ask the Court to draw distinctions from among Hanover's actions during the Final Week's Challenged Trades. In effect, they seek a finding that the purchases and sales Hanover carried out as agent for Appellants during the Final Week were strictly above board and in good faith, thereby disaggregating them from the fraudulent and unlawful activities Hanover's brokers were actively engaged in at that time, in particular during the last moments of the frenzy of fraud they perpetrated on February 24, 1995, when the bulk of the Challenged Trades in question occurred.

As a threshold matter, Appellants' contention must be placed in proper focus. It is essential to recall who Appellants are and the context in which their claims arise. A review of the evidence considered by the bankruptcy court highlights the difficulty inherent in Appellants' efforts to distance their trades from the rest of Hanover's Final Week activities. Appellants comprise eight of the much larger group of Hanover customers who were Claimants in the bankruptcy court proceedings that gave rise to this appeal.

In portraying the full scope of the Hanover's fraudulent scheme and the grounds that prompted the bankruptcy [**131] court to uphold the Trustee's disallowances, Judge [*458] Garrity identified several common threads that interweave the various Claimants' transactions.

. None of the Claimants received written confirmations of their February 24 Trades from Adler. With respect to those transactions, Adler affirmatively exercised contractual rights to refuse to proceed with the transactions when it became fully aware on February 23 of the extent of Hanover's financial trouble and deceit. The court also found that those trades never settled because the regulators closed Adler before the trades cleared. To this extent, Claimants in essence endeavored to compel a nonevent existing only in Hanover's fraudulent book entries. *See Decision*, 247 B.R. at 62.

. Some of the Claimants were deemed by Hanover as favored customers selected as beneficiaries of preferential treatment either as relatives or close friends of the Hanover brokers or because the brokers sought to secure their future business. *See id.* at 63, 85.

. None of the Blue Chips Buys Claimants sought the Trustee to deliver were paid for by Hanover; by the proprietary accounts Hanover used to pay for its purchases [**132] of Claimant's House Stocks; or by Claimants, none of whom had sufficient funds in their own accounts to pay for the purchases. *See id.* at 106. While in the aggregate the Claimants for whom Hanover acquired Blue Chips held a total of $ 400,000.00 in their accounts as of February 16, 1995, during the Final Week, Hanover booked into their accounts $ 18.7 million of Blue Chip purchases, $ 15.1 million by volume in the brief period Hanover operated on February 24. [31] *See id.* at 72, 106.

. The Hanover brokers sought deliberately to execute the Claimants' transactions in a manner intended to give them preferred SIPA claims in the event of Hanover's inevitable liquidation by systematically selecting for favored treatment, at a time they knew Hanover was insolvent, customers whose exchange of House Stocks for cash or Blue Chips would leave in their accounts less than $ 100,000.00 in cash [**133] and brand name stocks valued up to $ 500,000.00, which coincided with the limits of SIPA insurance protection. *See id.* at 63, 71, 96.

. Claimants constituted approximately nine percent of the 5,900 Hanover customers holding House Stocks who, by virtue of their being conferred preferential treatment by their Hanover brokers, were able to sell their securities to Hanover during the Final Week, although many more customers were unsuccessful in their efforts to sell. *See id.* at 71.

. All of Hanover's Challenged Trades constituted fraudulent acts actually intended by the Hanover brokers to hinder, delay or defraud Adler or its creditors (*see id.* 85-89) and designed to confer a substantial preferential benefit only on certain favored customers by giving them preferred SIPA claims and enhanced protection in Hanover's inevitable liquidation. *See id.* at 96.

. Hanover's fraud included manipulation of the price of the House Stocks through Fake Buys and Fake Short Sales calculated to maintain the appearance that the market value of those securities was higher than they were actually worth in an open, unmanipulated [**134] market, and therefore to maintain Hanover's accounts, as well [*459] as those of their favored customers, at inflated, artificial levels to enhance their value. *See id.* at 96, 104.

. The Hanover brokers who perpetrated the frauds for the benefit of their own accounts and those of their relatives and friends and other favored customers refused to testify about their activities, invoking their Fifth Amendment privilege against self-incrimination. Some of them, including the two brokers who handled Appellants' accounts, pleaded guilty to criminal violations of the securities laws in contention here. *See id.* at 88-89.

. Some Claimants produced no evidence that they authorized the Challenged Trades. *See id.* at 79. Others admitted that they did not authorize the Challenged Sales and/or Blue Chip Buys in advance. *See id.* at 76. While the bankruptcy court ruled that a number of Claimants, including Appellants here, presented enough evidence to satisfy their burden of demonstrating that they authorized the Challenged Trades, the court nonetheless, on other grounds, upheld the Trustee's disallowance of their claims to compel [**135] completion of the Blue Chip Buys and delivery of the securities.

The bankruptcy court found that the Claimants did not deny that "when Hanover was manipulating the price of the House Stocks, it realized that it was insolvent, that the Fake Buyers would not realize the cash they appeared to create in Hanover's proprietary account and that without that cash, Hanover could not pay for its 'purchases' of House Stocks from the Claimants." *Decision*, 247 B.R. at 96. Moreover, the court determined that Hanover's brokers did not merely intentionally overprice the House Stocks in order to deceive Adler and its creditors. Rather, they executed and booked into some Claimants accounts the fictitious trades "to create the appearance that their 'purchases' of the Claimants' House Stocks were bona fide transactions that reflected the true market value of those securities." *Id.* at 97. Absent these calculated devices, the appearance of a market for House Stocks would have crumbled under the pressure of the illegal short selling; Hanover would have been closed much sooner, and its brokers would never have had any ability or occasion for executing and posting into Appellants' [**136] accounts the Blue Chip trades Appellants here demand that the Trustee honor.

Assessing the totality of these circumstances, the bankruptcy court concluded that "all those actions were part of an *integrated scheme* which culminated in the execution of the Challenged Trades, but whose end was to vest the Claimants with preferred SIPA claims in the inevitable liquidation proceeding." *Id.* (emphasis added).

The integrated scheme that embraced all of Hanover's transactions during the Final Week, part and parcel of which included the trades Appellants seek to enforce, was systematically unified in method and purpose by the common threads discussed above. The transactions

[31] *See supra* n.11 for a discrepancy in the bankruptcy court's references to these figures.

that comprised and fostered Hanover's overall deceitful stratagem embraced, even if only in some incremental degree, those Hanover performed on behalf of Appellants with their admitted approval.

Accordingly, even if Appellants did not know of, intend or authorize foul play on their behalf, at the time Appellants authorized their Challenged Trades, Hanover was already engaged in a continuous scheme that was spun with misconduct purposely directed against Adler and its creditors. Based on the bankruptcy court's findings [**137] with regard to (1) Hanover's knowledge concerning its true financial [*460] condition, and (2) the brokers' wrongful motivations, every additional trade Hanover booked for its customers during the Final Week was recorded with full awareness and expectation that the transactions would not be completed. The record also supports a conclusion that the brokers were aware that if those trades were to be honored at all, payment for them would come, not from Hanover's assets, which did not exist for the volume of purchases it undertook, but from Adler and its creditors. Simply put, Hanover's Final Week's Challenged Trades reduce to this: that every transaction Hanover entered for a customer into Adler's books, authorized or not, was predicated for its existence and payment upon an act of deceit that was the practical equivalent of theft from Adler of a significant portion of the purchase price. Absent that form of larceny, none of the claims at issue would have materialized even as Hanover's book-entries. In fact, the benefit of that malfeasance is assumed and built into each of the Challenged Trades. *See* Restatement (Second) of Agency § 263, illus. 1 and 2.

From this perspective, Appellants' [**138] authorized trades were not discrete transactions isolated from the rest of Hanover's acts and from whose effects on the market Appellants benefitted only incidentally. Nor was Hanover's fraud merely collateral to the Challenged Trades. Rather, the record is sufficient to sustain a finding that Appellants' transactions became amalgamated into Hanover's fraudulent continuum and necessarily constituted a calculated extension of it. For when Appellants placed their orders to sell their House Stocks, Hanover as their authorized agent extended the misrepresentation to Adler that a market existed for the House Stocks at the posted prices, in this manner not only benefitting Appellants, but furthering Hanover's own interests and those of its other favored customers who stood to gain by a protraction of the appearance that a real fair market for House Stocks existed.

To this extent, Appellants' purchases and sales were no less tainted by deceit than the rest of Hanover's fraudulent transactions. The prices Hanover charged Appellants for the purchase of their House Stocks were no less manipulated. And the prices Hanover posted in Appellants' accounts could not have been fair and arms length [**139] as to Appellants' trades but deceitful as to other customers. Finally, Appellants' trades were just as much instruments intended to extend Hanover's fraud against Adler, and, concomitantly, Adler and its creditors were no less exploited by Hanover's booking Appellants' Challenged Trades in Adler's records, than by the other portions of Hanover's Final Week transactions that Appellants concede were unlawful. *See also Eitel v. Schmidlapp*, 459 F.2d 609, 615 (4th Cir. 1972) ("The principal cannot claim the fruits of the agent's acts and still repudiate what the agent knew….Defendant, by his own admissions, could not have been less interested in [the details of the transaction]. He was interested only in obtaining the profit…and he was perfectly content to leave the details as to how he obtained it to [his agent].").

For these reasons, Appellants cannot sever the portions of their fraud-tainted trades from the balance of Hanover's artifices and endow them with good faith. If the merchandise Hanover had deceitfully pushed upon the market were sour wine, the product as a whole would be no less contaminated because a few good grapes had been pressed in it. In the [**140] words of another court encountering an analogous proposition: "The facts are not to be atomized. Where a transfer is only a step in a general plan, the plan 'must be viewed as a whole with all its composite implications'." *In re Checkmate Stereo and Electronics,* [*461] *Ltd.*, 9 B.R. 585, 612 (Bankr. E.D.N.Y. 1981), *mod. and aff'd*, 21 B.R. 402 (E.D.N.Y. 1982) (quoting *Buffum v. Peter Barceloux Co.*, 289 U.S. 227, 232, 77 L. Ed. 1140, 53 S. Ct. 539 (1933)). [32]

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[32] In *Buffum*, as part of a concerted effort to defraud creditors and retain the debtor's property within the confines of relatives and friends, the debtor pledged stock certificates in the family corporation as security for indebtedness worth much less than the collateral. The pledge by itself constituted a preference that would have withstood challenge by the bankruptcy trustee because it was made more than four months prior to the petition. Reversing the appellate court's decision against the trustee, the Supreme Court found that the pledge was but a component of a larger fraudulent plan that entailed the distribution of the debtor's assets among family and friends. The court noted: "The unconsciousable sale is not be viewed in isolation, as something disconnected from the pledge, an accident or afterthought. It was the fruit for which the seed was

[**141] Arguments comparable to Appellants' attempt to disaggregate Hanover's fraud, so as to cleanly disentangle their transaction from their broker's integrated misconduct, were also considered and rejected by the Second Circuit in *United States v. Russo*, 74 F.3d 1383 (2d Cir. 1996), *cert. denied*, 519 U.S. 927, 136 L. Ed. 2d 213, 117 S. Ct. 293 (1996). [33] Defendants there, prosecuted for violations of the Securities Exchange Act, argued that their fraudulent scheme of short sales, which directly involved only blue chip stocks, were not made "in connection with" the broker's separate purchases of house stocks from customers. The Second Circuit rejected this theory. It recognized that defendants' manipulation scheme consisted of several components which they "used in tandem to keep K&C alive". 74 F.3d at 1388. The Circuit Court, noting that the short sales played an integral role in the scheme, stated:

> While the short sales did not affect the markets for [the house stocks] through actual trading, they enabled K&C to create a false impression of demand for the stock and to shield prices from the realities of the market without the money [**142] generated through the Short Sales, the Appellants would not have been able to keep large blocks of [house stocks] off the market or finance the other elements of the kiting scheme, thereby misleading the public as to the value of the [house]stocks…. K&C was the market maker for [the house stocks] -- there was no 'open market' on which it could trade except for the one it created, [*462] and it could not have continued to make this market without the money generated by the short sales…. K&C could not separate its fraud from its purchase of [house stocks].

Id. at 1391.

[**143] The point that emerges from these cases is that what matters in response to a claim of innocence is not so much what the claimants actually knew or intended. Rather, it is that, whatever their good faith, insofar as the claimants sought to avail themselves of the benefits of an agent's comprehensive fraudulent scheme, they cannot cleanly extract their own gems out of the mire.

(iv) *Appellants' Innocence*

Appellants plead innocence as their mantra. Inasmuch as they press the point so intensely, the Court feels obliged to address it with the thorough consideration the matter rightfully merits, for at bottom the argument touches upon philosophical issues that go to the core of our jurisprudence. Appellants' attempt to segregate their trades from the entire context and invoke their innocence must fail under the circumstances presented here. The Court cannot accept the premise of Appellants' supposed disassociation, for the same reasons that impelled Judge Garrity to reject it.

In essence, the theory suggests that amidst the "pandemonium" that prevailed at Hanover during its closing moments on the morning of February 24, 1995 [34] Appellants' brokers had the presence of mind to compartmentalize [**144] so as to neatly and clearly

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planted . . . The [pledgee corporation] set out to do something more than secure the payment of a debt. It became a party to a plan to appropriate a surplus and in combination with its debtor to hold his creditors at bay." *Buffum*, 289 U.S. at 233 (Cardozo, J.).

[33] In *Russo* defendants were employees of K&C, a securities firm that served as an introducing broker that underwrote initial public offerings and acted as market maker for the stocks associated with the IPOs. As occurred both here and in *Salmon*, K&C encountered difficulties complying with net capital requirements by reason of downward pressure on the prices of its house stocks and minimal demand for those securities at the prices the firm quoted. Also in apparent confirmation of the seeming constant recurrence of events, K&C, as Hanover did here, endeavored to maintain the appearance that a market existed for the house stock at the firm's stated prices. To this end, K&C devised a scheme to maintain prices artificially high that paralleled that of Hanover, disposing of the securities by entering them into customers' accounts through fictitious purchases.

As a source of cash to pay for the house stocks it was also buying from customers, the firm generated cash credits through short sales of blue chip securities for its own account. In doing so, it took advantage of an accounting error by K&C's clearing broker that made the cash available to K&C through credits in its account without freezing the proceeds to ensure coverage 'on demanding compliance with margin requirements.

[34] The bankruptcy court cites evidence that on February 24, John Devito, an employee of Adler instructed to go to Hanover's offices to report on what was occurring there, described having witnessed "pandemonium". *See Ensminger II*, 218 B.R. at 21. Devito testified that upon his arrival he encountered "massive chaos", with "people crying, people ripping things down, people walking around with baseball bats", and that when he attempted to convene a meeting with Hanover brokers he was physically attacked by one of Hanover's managers. *See id.*; Trustee's Brief at 11.

differentiate Appellants' trades as distinct transactions, entirely severed from the other purchases and sales they were conducting unlawfully for the purpose of defrauding Adler and SIPC, and in order to shield Appellants' bargains from the taint of the fraud and illegality that characterized and motivated the rest of the brokers' chicanery during those chaotic moments.

Perhaps the most fundamental flaw [**145] in Appellants' narrowly focused conceptualization of innocence lies in their overlooking the "integrated scheme" in Hanover's fraud. By their notion, Appellants dealt with Hanover from an insulated distance, as though linearly related to their broker through vertical connections across a void in which Appellants contributed nothing to the events at issue other than authorizing the Challenged Trades, by which fact alone they claim entitlement to the benefits of their bargains. This view of the world reflects a two-dimensional perspective. It takes no account of what role Appellants may have played in narrowing the distance between them and Hanover -- through the course of past dealings, through any special relations they may have maintained with their brokers, through the very authorizations they insist they gave Hanover to execute the Challenged Trades. In fact, Appellants' concept ignores that by these and other means they so could have shaped the contours of their relationships and configured associated events as to enable their unscrupulous agents to nourish and advance Hanover's nefarious business to a point that culminated in the incrementally enlarged criminality and frauds embodied [**146] [*463] in Appellants' portion of the Challenged Trades.

Appellants contend that, aware of bad news regarding Hanover, they repeatedly ordered the sale of their House Stocks, but that their brokers continually put them off by reassurances and false promises, until eventually their persistence paid off -- coincidentally during the Final Week and in particular on Hanover's last day in business. This argument overlooks that at that point, as already discussed above, the execution of Appellants' trades became entangled in the extensive fraud Hanover was then perpetrating. Accordingly, that Appellants somehow were included among the select society whose calls to Hanover were answered on February 24, 1995 and who thus were favored with the fruits of Hanover's systematic, fraudulent largesse, may have been no accident. Hanover's brokers knew then that the firm was insolvent and that they intended to defraud Adler and SIPC for the very purpose of bestowing unique value upon themselves and their favored customers, including Appellants, that would place their claims at a distinct advantage over those of many thousands of other Hanover customers not so chosen to receive the brokers' deceitful beneficence.

[**147] The view of the world Appellants' theory espouses, this Court believes, is not sustained by reality. Nor does it accord with the geometry of the law or the symmetries of life. In fact, Appellants' relationships to Hanover and Adler evidenced in these proceedings cannot be conceived as discrete perpendicular lines implicating only Appellants' singular claims and unitary interests. By its very terms, a bankruptcy is akin to a zero-sum game. Typically, the numerous claims against the debtor far exceed the value of the estate. Few creditors are able to receive the entire value of their claims. Accordingly, the more any one claimant recovers, the less will be left for others. Any claim paid at or near full worth necessarily diminishes the size of the debtor's estate, and thus comes at the expense of all other creditors. *See Young v. Higbee*, 324 U.S. 204, 89 L. Ed. 890, 65 S. Ct. 594 (1944).

For these reasons the underlying philosophy of the Bankruptcy Code and SIPA establishes certain equitable principles and priorities designed to maximize assets available for ratable distribution to all creditors similarly situated. *See Jewel Recovery, L.P. v. Gordon*, 196 B.R. 348, 352 (N.D. Texas 1996) [**148] (citing *Higbee*, 324 U.S. at 210 n.8). To this end, the rules seek to prevent unjust enrichment and to avoid placing some claims unfairly ahead of others by distinguishing transactions truly entered in good faith and for value from those somehow induced and tainted by preference, illegality or fraud. *See id.; see also Investors Ctr.*, 129 B.R. at 353 ("Repeatedly this Court has been forced to tell claimants that the fund created for the protection of customers of honest, but insolvent, brokers gives them no protection when the insolvent broker has been guilty of dishonesty, breach of contract or fraud.").

There is an alternate way to regard events here at issue that better reflects the overall statutory framework of the Bankruptcy Code and SIPA. Taking all other relevant interests into account, Appellants' claims must be considered not in the isolation of Appellants' linear ties to Hanover, but in the light of Hanover's actions and Adler's consequent bankruptcy as well. From the perspective of these broader interrelations, the pertinent connections and effects that should be reckoned here spread not just vertically to reach Appellants' claims, but horizontally [**149] to touch the legitimate interests and expectations of the thousands of other creditors [*464] of Adler. The larger universe would expand to consider the bankruptcy's impacts on Adler customers situated at a far more arm's-length distance from the events in question: those who maintained no accounts at Hanover but who nonetheless were affected by Hanover's fraud that precipitated Adler's collapse [35]; those who did not engage unethical agents, and cannot seek to avail themselves of advantages and bargains created for them by fraudulent misdeeds; those whose relations to Hanover did not qualify them to rank among the select few chosen to gain from the Hanover brokers' preferences and whose bona fides are thus not propped up by reliance upon benefits bestowed by the unlawful means of agents. In sum, from this broader outlook, in a world of original sin, Appellants' invocation of innocence is a relative thing and their claims for relief must be assessed in these relative terms.

[**150] In this view of things, Hanover's calculated fraud cannot be contained, as Appellants' hypothesis would have it, only within Hanover, as though spending its force in a void, and never implicating some of its intended beneficiaries just beyond Hanover's borders. Put another way, Appellants' transactions and relations with Hanover cannot be perceived as islands entire unto themselves, somehow uninvolved, and somehow unengulfed by the ocean of corruption that surrounded Hanover's whole fraudulent course of dealings on behalf of and profiting Appellants and other select customers during Hanover's final hours.

2. *Avoidance Pursuant to 11 U.S.C. § 548(a)(1)(B)*

As an additional ground for avoiding the Challenged Trades, the Trustee asserted a constructive fraud claim under § 548(a)(1)(B). [36] The Trustee sought to demonstrate that: (1) Adler received less than a reasonably equivalent value in exchange for the obligations it purportedly incurred or the transfers it made in connection with the Challenged Trades and that (2) at the time such obligation or transfer occurred, Adler was either insolvent or was engaged or about to engage in a business or transaction [**151] for which its remaining property constituted unreasonably small capital. *See* 11 U.S.C. § 548(a)(1)(B).

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Unlike the requirements of § 548(a)(1)(A), the criteria applicable to § 548(a)(1)(B) are objective. For the Trustee to prevail, no element of intent or state of mind on the part of Hanover is required to be imputed to Adler or to Appellants. To this extent, the relevant inquiry and the bankruptcy court's determinations under both elements rest on factual findings. On this appeal, these questions [*465] of fact are reviewable for clear error. *See* Fed. R. Bankr. P. 8013; *Andersen*, 470 U.S. at 573-74.

The bankruptcy court found that the Trustee had sufficiently established both requirements of § 548(a)(1)(B) and thus was entitled to avoid the Challenged Trades on this independent basis. Appellants take issue with the bankruptcy court's factual findings with regard to both elements of the § 548(a)(1)(B) determination. They also contend that the bankruptcy court erred by (i) failing to address their defense under § 548(c) that they gave Adler value in good faith in connection with the Challenged Trades and (ii) not giving adequate consideration to Appellants' defense that the Challenged Trades constituted settlement payments or margin payments protected by § 546(e) [**153] of the Bankruptcy Code from the Trustee's avoidance power under § 548(a)(1)(B). The Court will consider these arguments in turn.

a. *Reasonably Equivalent Value*

Appellants assert various ways by which Adler received reasonably equivalent value for the cash credits Hanover entered into their accounts in connection with

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[35] Adler served as clearing firm for 42 introducing broker-dealers, including Hanover. At the time of its closing it had approximately 66,000 active customers, of which Hanover accounted for 15,500. *See Decision*, 247 B.R. at 65.

[36] Section 548(a)(1)(B) provides:

> The Trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily…(B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and (ii) (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation; (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

11 U.S.C. § 548(a)(1)(B)

the Challenged Sales, triggering Adler's obligation to pay for the purchases in the event Hanover failed to do so. They contend that the bankruptcy court erred in not considering all of the circumstances affecting the value Adler received in exchange for clearing and settling Appellants' Sales and Blue Chip Buys. *See* Appellants' Brief at 79-82. First, Appellants argue that Adler's ability to use the House Stocks it held to effect a buy-in of the Illegal Short Sales represented value to Adler in that Adler possessed, in a cornered market, the potential to realize millions of dollars of value embedded in the pent-up demand for House Stocks created by the Illegal Short Selling. Under Appellants theory, Adler could have issued a buy-in notice and forced the Short Sellers to deliver all the House Stocks they sold short, and thereafter, because the sellers had nowhere [**154] else to go but Adler, could have raised the price. *See id.* at 77, 79-80. Appellants contend that in these circumstances the House Stocks "had actual, realizable cash value, at minimum, reasonably equivalent to the price paid". *Id.* at 80.

Appellants also maintain that in connection with the Blue Chip transactions Adler received further value in the forms of (1) the cash in Appellants' accounts; (2) the House Stocks and their proceeds, which constituted security for Hanover's obligation to pay for the Challenged Sales; (3) Appellants' enforceable obligation to pay for the Blue Chips; and (4) a lien on any Blue Chips Adler acquired for them that would secure Appellants' obligation to pay the purchase price. *See id.* at 82.

On the extensive factual record before it, including a trial on the merits of the various issues Appellants' raise, and weighing the reports and testimony of the parties' respective experts, the bankruptcy court rejected Appellants' arguments. The court found that, contrary to Appellants' assertions, Adler did not intend to effect a buy-in of the Illegal Short Sales of House Stocks. *See Decision*, 247 B.R. at 106. Moreover, the court ruled [**155] that Adler's intent and ability to carry out such a buy-in, as well as the prices the Trustee actually obtained in buy-in the Trustee conducted in late March 1995, were irrelevant to the question of the value Adler received from Appellants weeks earlier in connection with the Challenged Trades. *See id.* at 107. The court concluded that the only value Adler actually received in connection with the Challenged Trades was the House Stocks that Hanover's book entries transferred [*466] from Appellants' accounts to Hanover's proprietary account.

(i) *Date of Valuation*

In assessing the value of those securities, the bankruptcy court rejected the Claimants' argument that the manipulated House Stock prices which prevailed during the Final Week represented the proper measure for determining reasonably equivalent value. Instead, the court accepted the Trustee's argument that because of Hanover's manipulation of House Stock prices prior to and during the Final Week, the most appropriate market prices to be applied to appraise the House Stocks were those that would have prevailed as of February 16, 1995 absent Hanover's fraud. [37] Noting that once Hanover was out of business, and [**156] thus unable to manipulate the market, House Stocks prices dropped sharply by 75%, the court adopted House Stock prices recorded on February 27, 1995 as the most accurate reflection of the House Stocks' fair market worth as of February 16 for § 548(a)(1)(B) purposes. *See id.* at 110. Applying those prices, the court found that Adler did not receive reasonably equivalent value in connection with the Challenged Trades.

For the purposes of § 548(a)(1)(B), the Bankruptcy Code defines "value" as "property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor." 11 U.S.C. § 548(d)(2)(A). However, § 548(a)(1)(B) [**157] contains a critical qualification. The value that is exchanged and received by the debtor must be "reasonably equivalent." 11 U.S.C. § 548(a)(1)(B). This concept has been equated to something akin to fair market value. *See BFP v. Resolution Trust Corp.*, 511 U.S. 531, 545, 128 L. Ed. 2d 556, 114 S. Ct. 1757 (1994); *see also Barber v. Golden Seed Co., Inc.* 129 F.3d 382, 387 (7th Cir. 1997) ("The standard for 'reasonable equivalence should depend on all the facts of each case,' an important element of which is fair market value.") (citations omitted); *Mellon Bank, N.A. v. Official Comm. Of Unsecured Creditors of R.M.L., Inc. (In re R.M.L., Inc.)*, 92 F.3d 139, 149 (3d Cir. 1996) ("'The touchstone is whether the transaction conferred realizable commercial value on the debtor'.") (citations omitted); *Davis v. Suderov (In re Davis)*, 169 B.R. 285, 299 (E.D.N.Y. 1994) ("Absent unusual circumstances, [fair market value] will typically be the controlling

[37] That date corresponds to the point in time when, according to the bankruptcy court, Hanover experienced a net capital deficiency that would have warranted its being closed by the regulators. *See Decision*, 247 B.R. at 112.

consideration.") (citations omitted).

Applying this standard, this Court sees no clear error in the bankruptcy court's factual findings and concurs [**158] in its judgment. The Court notes at the outset that generally whether a transfer is for "reasonably equivalent value" is largely a question of fact, as to which considerable latitude must be allowed to the bankruptcy court as the trier of the facts. Moreover, the determination of reasonably equivalent value depends on all the circumstances surrounding the transaction. *See* 5 *Collier* P 548.05 [1][b], at 548-35.

None of the forms of value Appellants argue Adler received, singly or combined, rises to a level that may be deemed "reasonably equivalent" commercial value. First, the statute requires that the debtor must have "received" the value in question "in exchange" for the transfer or obligation at stake. An unperformed promise to pay or to deliver securities in the future, after the debtor has completed [*467] the transfer or incurred the obligation, cannot satisfy the concept of a fair exchange. The requirement that the debtor must have "received" the value in question expresses a temporal condition demanding an element of contemporaneity in the determination of whether something close to the reasonable equivalence has been exchanged. Full performance on the debtor's [**159] part in return for an executory promise to perform on the other party falls short of the requisite standard of equivalent worth at the time of the transaction. Under § 548(d)(2)(A), the term "value" would exclude future considerations, at least to the extent they remain unperformed. *See Bailey v. Metzger, Shadyac & Schwartz (In re Butcher)*, 72 B.R. 447 (Bankr. E.D. Tenn. 1987); 5 *Collier* P 548.07[2][a], at 548-63; P 548.05[1][b], at 548-39 ("The language section 548(d)(2)(A), seeming to contemplate only a present advance, or transfer of property as security for, or the discharge of, an antecedent debt, generally leaves no room for a mere executory promise to constitute value.").

(ii) *The Potential Buy-In Value*

For the same reasons, this Court finds no clear error in the bankruptcy court's decision not to credit Appellants' theory claiming intrinsic value embedded in the buy-in Adler allegedly had the potential to realize. The pertinent inquiry regarding reasonably equivalent value requires a determination not only as to the sufficiency of the value given, but also as to whether the value was received in exchange for the transfer in question. [**160] The notion of a fairly contemporaneous exchange of value suggests some element of consciousness or recognition among the parties concerning the particular interest in property at issue and the value being traded. The bankruptcy court rejected Appellants' allegations that Adler intended to conduct a buy-in.

This court finds no sustainable evidence on the record to suggest that at the time of the transfer or obligation in connection with the Challenged Trades, Adler or the Appellants or even Hanover contemplated that the reasonably equivalent consideration they understood they were trading in exchange for the House Stocks was Adler's claimed ability to pursue the Short Sellers in a buy-in. Appellants' theory that Adler was in a position to realize value locked in the House Stocks is besides the point in a determination as to whether that supposed value reflects the actual consideration Appellants or Hanover had in mind giving, or that Adler understood it was gaining and actually received, in exchange for the transfer of securities or cash associated with the Challenged Trades.

Moreover, to the extent Appellants claim that what they, or Hanover as their agent, gave Adler as value in [**161] the exchange for Adler's obligation to deliver the Blue Chips was the worth Adler could have obtained from the House Stocks by capitalizing on its ability to effectuate a buy-in of the Illegal Short Sales, Appellants' argument implicitly acknowledges that the value Appellants claim they gave was not then actual or current. Rather, it depended on a contingency: Adler's ability at a future point to secure the full value contained in the exchange, so as to render it reasonably equivalent to what the House Stocks purportedly were worth in perhaps the only real market existing for them. Consequently, in order for Adler to receive the alleged true value, it had to undertake, at some risk, a buy-in whose viability or net yield could not be projected with any degree of certainty at the time of the exchange. To this extent, the hypothetical buy-in represented a proposition speculative at best, trading a hope of recovery in [*468] exchange for a current and quantifiable obligation on Adler's part to deliver particular Blue Chip securities.

In any event, insofar as Appellants argue that Adler contemplated such a buy-in, the bankruptcy court ruled otherwise as a factual matter. Appellants contest Judge [**162] Garrity's determination. This conclusion rests on issues of fact made by the bankruptcy court after a full examination of the record and following a trial. This Court, having examined that record, holds that

Judge Garrity's determination is supported by substantial evidence and finds no clear grounds for a reversal of the bankruptcy court's judgment in this regard.

With regard to the cash Appellants claim they held in their accounts that could be applied to the purchase of the Blue Chips, the bankruptcy court found that none of the Claimants' accounts had funds sufficient to pay for the Blue Chips. According to the court, the Claimants who purchased Blue Chips maintained, in the aggregate, less than $ 400,000.00 in their accounts as of February 16, 1995, as against a total of between $ 13.3 million and $ 18.5 in Blue Chip Buys booked into their accounts during the Final Week. *See Decision*, 247 B.R. at 72, 107.

Pertaining specifically to Appellants in this proceeding, the Trustee estimates that altogether the customers had approximately $ 38,000.00 in their accounts during that period and with this amount purportedly purchased more than $ 3 million in Blue Chips. [**163] *See* Trustee's Brief at 67. [38] There were also no actual "proceeds" of the Challenged Sales in Appellants' accounts because Hanover never paid for those trades. In fact, the bankruptcy court specifically found that Hanover was neither able to nor intended to pay for them. *See Decision*, 247 B.R. at 96, 104.

Appellants' remaining arguments fair no better under close scrutiny. As earlier stated, Appellants' purported promise or obligation to pay for the Blue Chips, even if enforceable, does not equate to "reasonably equivalent" value measured as of the time of the exchange. Their lien hypothesis is unavailing because, as the bankruptcy [**164] court noted, it assumes the Blue Chips were delivered. *See Decision*, 247 B.R. at 107. The Trustee's records, however, contained no evidence that the Blue Chips were ever received by Adler's estate. *See id.* (citing *Ensminger I*, 218 B.R. at 27).

Finally, Appellants contend that the supposed buy-in could have garnered a substantial windfall for Adler reflecting House Stock prices, at a minimum, comparable to those Hanover posted during the Final Week. This Court is satisfied that the bankruptcy court dealt convincingly with the issue. The methodology the bankruptcy court employed, which assumed the House Stocks' market prices as of February 27, 1995 is not unreasonable, particularly given the empirical evidence that the value of those securities plummeted by 75% on the day following Hanover's closing and the cessation of the price manipulation that had previously sustained the artificial values. [39] According to Judge Garrity,

[*469]

> While we can attribute some of that decline to the fact that Hanover was no longer acting as a market maker for the [House] Stock[s]… we find that it was largely attributable to the fact that Hanover was no longer [**165] creating an illusion of demand.

Id., 247 B.R. at 110. Similar precipitous drops in the value of house stocks were recorded in other cases where the primary market-maker, which had engaged in fraudulent trades to maintain the appearance of a market at inflated prices for house stocks, was forced to close down. *See Russo*, 74 F.3d at 1389; *Salmon I*, at 5.

Nor does the Court find persuasive Appellants' insistence that the value the Trustee obtained from the buy-in the Trustee conducted on March 20 and 29, 1995, which garnered [**166] the Adler estate $ 17 million, is a better indicator of what the House Stocks were worth on February 16, 1995. *See* Appellants' Brief at 23-24; Appellants' Reply at 32. Whatever may have been the House stock prices in late March 1995, the only value that is relevant for the purposes of § 548(a)(1)(B) is that of the prevailing prices recorded at the time the Challenged Trades were booked. *See Cooper v. Ashley Comm., Inc. (In re Morris Communications NC, Inc.)*, 914 F.2d 458, 466 (4th Cir. 1990); 5 *Collier* P 548.05[1][b], at 548-38 ("Neither subsequent depreciation nor appreciation in the value of the consideration affects the question of whether reasonably equivalent value was given."). The

[38] This figure represents a computation made at a time when Appellants comprised nine Hanover customers. Since then, former Appellant Michael Polselli settled his claim and withdrew from this appeal. *See supra* n.2. It is not certain whether Polselli's withdrawal would affect the Trustee's calculation of Appellants' aggregate cash position during Final Week.

[39] The Trustee asserts that in the five years that have elapsed since Hanover's closing, the House Stocks never recovered value to prices anywhere near those posted during the Final Week. *See* Trustee's Brief at 61. One-and-one-half years after Hanover's close, every one of the House Stocks was trading at less than 25% of the February 27, 1995 prices, or about one-sixteenth of the Challenged Sales prices. *See id.* (citing Trustee's Ex. 72.)

bankruptcy court was not bound by the prices Hanover posted as a measure of fair value in light of the overwhelming evidence that those prices were manipulated and Hanover's inability to find a market. *See Salmon I*, at 20.

b. *Adler's Insolvency*

The bankruptcy court also found that the Trustee had met his burden of establishing the second element required for avoidance of a debtor's transfer or obligation under § 548(a)(1)(B) -- that at the time [**167] of the Challenged Trades Adler was insolvent or operating with unreasonably small capital. *See* 11 U.S.C. § 548(a)(1)(B). The Bankruptcy Code provides that a debtor is insolvent when "the sum of such entity's debts is greater than all of such entity's property, at a fair valuation." 11 U.S.C. § 101(32)(A).

In determining "fair valuation" of Adler's worth, the bankruptcy court applied a "deathbed" valuation rather than the standard of a going concern. *See Decision*, 247 B.R. at 111 (citing *In re Taxman Clothing Co.*, 905 F.2d 166, 170 (7th Cir. 1990)) ("going concern value is not the proper standard if the business is 'on its deathbed'") (citation omitted); *Langham, Langston & Burnett v. Blanchard*, 246 F.2d 529, 532 (5th Cir. 1957). The "deathbed" indicators the bankruptcy court found relevant included "ongoing fraud, struggling to stay in business before fraud is discovered, fraud used in an attempt to alleviate cash flow problems and an inability to reorganize post-bankruptcy." *Decision*, 247 B.R. at 111.

The bankruptcy court also relied on the evidence presented at [**168] trial by the testimony of the Trustee's two experts, who agreed that both Hanover and Adler were insolvent as of February 16, 1995. The court's determination of Adler's insolvency as of February 16 was premised on an appraisal of the fair market value Hanover's inventory of House Stocks which the [*470] court concluded was far less than its worth at Hanover's quoted prices. To this end, the court again assumed that the most accurate reflection of House Stocks' real value was that in a market unaffected by Hanover's manipulation. Accordingly, the court adopted the assumption of the House Stocks' February 27, 1995 prices that it had earlier employed in connection with determining the element of reasonably equivalent value. *See id.* at 113.

Ascribing a value of $ 10.3 million to the House Stocks in Hanover's proprietary account at February 27 prices, the court concluded that on February 16, 1995 Hanover had negative net worth of $ 16.9 million and Adler nearly $ 6 million. *See id.* at 113-14. The court noted that the Claimants' expert disagreed with the use of the February 27, 1995 market prices for valuating the House Stocks in computing Hanover's solvency, [**169] but otherwise did not object in any meaningful way to the methodology used by the Trustee's experts. *See id.* at 111-12.

Appellants' sole challenge to the bankruptcy court's ruling is that it depended entirely on employing the February 27, 1995 prices as representing fair value of Hanover's House Stocks on February 16. *See* Appellants' Brief at 82-83. Appellants contend that the court's methodology ignores the real cash value of the House Stocks to Hanover and Adler through the prospect of buy-ins of the Illegal Short Sales. *See id.* This Court has already concluded that the bankruptcy court did not clearly err in assuming that the February 27, 1995 market prices fairly stated the House Stocks' real value on February 16, 1995. On this basis, the Court upholds Judge Garrity's determination that, for the purposes of the Trustee's avoidance of the Challenged Trades pursuant to § 548(a)(1)(B), Adler was insolvent on February 16. The bankruptcy court's reasoning and methodology accords with the approach followed by the court in *Salmon I* under somewhat comparable facts in sustaining an avoidance under § 548(a)(1)(B). *See Salmon I*, at 17-24.

3. *Defense* [**170] *of Value Given Pursuant to 11 U.S.C. § 548(c)*

Appellants argue that the bankruptcy court failed to address the defense they asserted under § 548(c) of the Bankruptcy Code. That provision states that a transferee

> that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

11 U.S.C. § 548(c). Appellants contend that they acted in good faith and gave value in the form of the House Stocks in exchange for the cash and securities Adler credited to their accounts at Hanover's posted prices, and that they thus are entitled to retain those interests and enforce Adler's obligation to complete the Challenged Trades to the extent of the value given. *See* Appellants' Brief at 68-69. With regard to the Blue Chip Buys, Appellants argue that Adler received (1) the

House Stocks and their proceeds and (2) Appellants' obligations to pay the purchase price.

Appellants maintain that the bankruptcy court erred by not preserving purported [**171] value that Appellants gave which they claim at least equaled or exceeded the value of the transfers the Trustee seeks to avoid and by ignoring Appellants' rights to pay for the Blue Chip Buys in the event their House Stocks Challenged Sales were avoided. *See id.* at 69.

Appellants' § 548(c) arguments rest on essentially the same legal and factual [*471] grounds they offer to support their §§ 548(a)(1)(A) and 548(a)(1)(B) claims: their good faith, and the value they purportedly gave in exchange for the Challenged Trades. The asserted value included Appellants' House Stocks and proceeds in their accounts reflected at the prices at which Hanover purchased their House Stocks, the potential value to Adler of a buy-in and Appellants' obligation to pay the purchase price of the Blue Chips. Each of these issues was effectively subsumed in the bankruptcy court's analysis under §§ 548(a)(1)(A) and 548(a)(1)(B) discussed above.

Because the factual and legal predicates upon which the bankruptcy court's determinations under § 548(a)(1)(A) and § 548(a)(1)(B) effectively foreclose application of § 548(c) elements that depend on similar findings, Appellants suffered no prejudice by [**172] the bankruptcy court's failure to respond to their § 548(c) argument.

As a threshold matter, by its very terms § 548(c) provides that, in order to invoke this defense, the transferee must satisfy three standards: take (1) for value *and* (2) in good faith, and (3) claim the applicable right to the interest only to the extent the transferee gave value to the debtor in exchange. A finding against the transferee on any of these elements would bar application of § 548(c). *See, e.g.*, 5 *Collier* P 548.07[2][a], at 548-62 ("Awareness of fraudulent purpose of a transaction is obviously inconsistent with good faith." Here, the bankruptcy court's findings with regard to the Trustee's applications for avoidance of the Challenged Trades under § 548(a)(1)(B), which this Court affirmed above, sufficiently treat the question of value Appellants gave, while the Court's conclusions relating to the Trustee's common law claims discussed below, similarly dispose of Appellants' good faith argument. For these reasons, this Court finds no basis for Appellants' § 548(c) defense.

4. *Defense of Settlement Payments or Margin Payments Pursuant to § 546(e)*

As an additional [**173] challenge to the Trustee's avoidance application under § 548(a)(1)(B) and other applicable law, Appellants assert the protection afforded to settlement payments and margin payments under the "stockholder defense" of § 546(e). [40] That provision carves out an exemption for certain transfers from the application of § 548(a)(1)(B) and other avoidance provisions of the Bankruptcy Code. *See* 11 U.S.C. § 546(e). The defense applies if the transfer qualifies as (1) a margin payment or a settlement payment (2) made by or to any of the specifically identified securities trade entities. *See id.; Munford v. Valuation Research Corp. (Matter of Munford, Inc.)*, 98 F.3d 604, 610 (11th Cir. 1996), *cert. denied*, 522 U.S. 1068, 139 L. Ed. 2d 675, 118 S. Ct. 738 (1998); *Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.)*, 952 F.2d 1230, 1236-37 (10th Cir. 1991), *cert. denied*, 505 U.S. 1213, 120 L. Ed. 2d 887, 112 S. Ct. 3015 (1992) (herein "*Kaiser II*"); *Zahn v. Yucaipa Capital Fund*, 218 B.R. 656, 675 (Bankr. D.R.I. 1998).

[**174]

The Bankruptcy Code defines a "settlement payment" as "a preliminary settlement [*472] payment, a partial settlement payment, an interim settlement payment; a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade." 11 U.S.C. § 741(8). "Margin payment" is defined as a

> payment or deposit of cash, a security, or other property, that is commonly known to the securities trade as original margin, initial margin, maintenance margin, or variation margin, or as mark-to-market payment, or that secures an obligation of a participant in a securities clearing agency.

11 U.S.C. § 741(5). If a transfer qualifies as either a settlement payment or a margin payment as defined, the bankruptcy trustee is not empowered to avoid the transaction except as an actual fraudulent conveyance

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[40] 11 U.S.C. § 546(e) provides: "Notwithstanding sections 544, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, or securities clearing agency, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title."

under § 548(a)(1)(A). *See* 11 U.S.C. §§ 546(e), 741(5).

a. *The Parties' Arguments*

Appellants, citing the plain language of the statute, argue that their portions of the Challenged Trades constituted both settlement payments and margin payments. In support, they review [**175] the movement of cash and securities of the settlement process of their transactions, as reflected in Adler's records, and point out that Appellants' House Stocks were on deposit with Hanover at the time they placed the order to sell. In furtherance of those instructions, Adler debited the House Stocks out of Appellants' accounts and into Hanover's Proprietary Account, simultaneously debiting cash out of Hanover's Proprietary Account and into Appellants' accounts. *See* Appellants' Brief at 73; *Decision*, 247 B.R. at 71. Regarding the Blue Chips, Adler debited cash representing the purchase price from Appellants' accounts, and credited the Blue Chips to those accounts. *See Decision*, 247 B.R. at 71. Appellants conclude that these debits and credits constitute the book-entry transfer of securities that, as regard the House Stock Sales, is complete as of trade date, eliminating the customers' stock position. *See* Appellants' Brief at 73-74 (citing *Bell & Beckwith*, 821 F.2d at 340).

In support of their margin payment argument, Appellants assert that the House Stocks and their proceeds secured payment to Adler, a participant in the [**176] NSCC, a securities clearing agency. *See id.* The Blue Chip Buys were reported to the NSCC, which generated contract sheets identifying the transactions and Adler held the House Stocks or their cash proceeds as security for the Appellants' obligation to pay for the Blue Chip Buys. *See id.*

Appellants also argue that the Bankruptcy Code's definition of "transfers" does not limit the term to an actual conveyance of ownership of property that remains incomplete until settlement date. Rather, they maintain that § 101(54) would encompass as transfers the debits and credits in Appellants' and Hanover's accounts because these entries record conveyances of "an interest in property". [41] *See* Appellants' Reply at 21. Thus, Appellants argue that even if the book-entry debits and credits in their accounts and Hanover's books created only Adler's obligation to deliver cash and securities to Appellants, these transactions nonetheless constitute transfers of an interest in property. *See* Appellants' Reply at 22 (citing [*473] *Barnhill v. Johnson*, 503 U.S. 393, 118 L. Ed. 2d 39, 112 S. Ct. 1386 (1992)); S. Rep. No. 95-989, at 27 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, [**177] 5813; [42] 5 *Collier* P 548.02[1][a].

The Trustee counters that the "stockbroker defense" [**178] applies, if at all, only to the grounds under § 548(a)(1)(B) and New York fraudulent conveyance law upon which the bankruptcy court's judgment rests. He asserts, however, that § 546(e) does not apply at all to this case. First, the Trustee argues that even applying the plain language of § 546(e), the statute does not protect the trades Appellants seek to enforce. The Trustee posits that § 546(e), by its terms, shelters from the Trustee's avoidance powers only a "transfer" that constitutes a margin or settlement payment made before the commencement of the case. *See* Trustee's Brief at 73.

By this theory, what the Trustee seeks to avoid here are not "transfers" Adler made, but "obligations" Appellants claim Adler incurred during the Final Week. Arguing that the Bankruptcy Code's avoidance provisions treat the making of transfers and the incurrence of obligations as distinct concepts, the Trustee focuses on the language of § 548, which authorizes avoidance of "any transfer of an interest, or any obligation incurred". 11 U.S.C. § 548(a). Based on this provision, the Trustee reasons that § 546(e) applies only to a "transfer" made, and not to an obligation [**179] incurred by the debtor. Trustee's Brief at 74. The Trustee thus concludes that § 546(e) protects only the *actual* movement of securities and

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[41] Bankruptcy Code § 101(54), upon which Appellants rely, defines "transfer" as

> every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption.

11 U.S.C. § 101(54).

[42] The legislative history Appellants quote states:

> A transfer is a disposition of an interest in property. The definition is as broad as possible. Many of the potentially limiting words in current law are deleted, and the language is simplified. Under this definition, any transfer of an interest in property is a transfer, including a transfer of possession, custody, or control even if there is no transfer of title, because possession, custody, and control are interests in property.

Id.

cash and that the evidence here establishes that no cash or securities actually changed hands before settlement was complete.

Second, the Trustee maintains that application of § 546(e) under Appellants' reading, would "substantially impede the fair and effective operation of SIPA." *Id.* at 75 (citing *SIPC v. Charisma Sec. Corp.*, 506 F.2d 1191, 1195 (2d Cir. 1974)). [43] This follows, the Trustee argues, by reason of Hanover's admitted frauds, which, if not imputed to Adler, would defeat avoidance under § 548(a)(1)(A) and thus effectively countenance enforcement of transactions calculated to defraud SIPC.

[**180] Third, the Trustee contends that § 546(e) has no application in the absence of bona fide securities trading and that there were no such transactions here because no actual exchange of any consideration occurred, and hence no real transaction against which to apply settlement payments. Finally, the Trustee holds that applying § 546(e) as construed by Appellants to enforce their trades would conflict with the policy underlying the statute and defeat its purpose. Specifically, he argues that the statute protects securities transactions only insofar as executed in the ordinary course of business and that § 546(e) was not intended to protect trades that occur outside the ordinary [*474] course of business, such as those motivated by demonstrable manipulation and other fraud. Under the Trustee's theory, since the Challenged Trades cleared only through Adler, cancelling the transactions would not occasion adverse effects on other entities in the securities clearing network. In other words, the affected industry would not be threatened with the spread to other brokerage houses of the chain reaction of potential insolvencies that § 546(e) was designed to avert.

b. *The Bankruptcy Court's Rulings*

[**181] The bankruptcy court ruled that the definitions of "settlement payment" and "margin payment" contained in § 741 of the Code apply here because § 546(e) incorporates them by reference. *See Decision*, 247 B.R. at 104. While acknowledging that many courts define "settlement payment" broadly to include any transfer made toward the completion of settlement regardless of the date in the process when such transfer occurs, the court rejected Appellants' arguments.

The court agreed that the Trustee had established that "Hanover hatched a plan to create fraudulent SIPA claims, not bargained-for exchanges of cash and securities." *Id.* Sustaining this finding, the court cited evidence demonstrating that (1) Hanover's House Stocks "buys" during the Final Week were false; (2) Hanover dictated which of its customers could "sell" securities; and (3) the Challenged Sales could not have occurred without the Fake Buys, since Hanover would not have had any "cash" with which to "pay" over to the Claimants the proceeds of the sales and the Blue Chips. On this basis, the court reiterated that "[Hanover's] brokers engaged in criminal and other wrongful acts in booking the Challenged [**182] Trades, and they did so to enhance the SIPC claims of the Claimants, not to have the trades performed." *Id.*

The bankruptcy court disagreed with the Trustee's argument that SIPA effectively nullifies § 546(e). The court also declined to resolve the parties' dispute over the construction of the terms "settlement payment" and "margin payment", holding that regardless of how broadly the terms were defined, § 546(e) does not protect the Challenged Trades from the Trustee's avoidance under § 548(a)(1)(B). As grounds for this conclusion, the court stated that "the Challenged Trades are the result of Hanover's massive fraud, not ordinary course transfers, and the statute simply does not insulate transactions like these from attack under § 548(a)(1)(B) of the Bankruptcy Code." *Id.* at 105 (citing *Wider v. Wootton*, 907 F.2d 570, 573 (5th Cir. 1990)); *In re Integra Realty Resources*, 198 B.R. 352, 360 (Bankr. D. Colo. 1996). The Court further reasoned that any other result is contrary to the goals of § 546(e) because it would undermine rather than promote investor confidence by endorsing a scheme to defraud SIPC. *See id.*

c. *Applicability* [**183] *of the Defense*

As a point of departure, in any matter involving statutory construction, judicial inquiry begins with the text of the statute. The court must first examine whether the plain language is unambiguous, and there end the search if on its face the wording is clear enough to leave no room for doubt or further interpretation. *See Hartford*

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[43] The Bankruptcy Code applies to SIPA liquidations only to the extent consistent with SIPA. Section 78fff(b) of SIPA provides that:

> To the extent consistent with the provisions of this chapter, a liquidation proceeding shall be conducted in accordance with [various provisions of the Bankruptcy Code, including Chapter 5].

15 U.S.C. § 78fff(b).

Underwriters Ins. Co. v. Union Planters Bank, N.A., 530 U.S. 1, 6, 120 S. Ct. 1942, 147 L. Ed. 2d 1 (2000) ("when 'the statute's language is plain, "the sole function of the courts" -- at least where the disposition required by the text is not absurd -- is to enforce it according to its terms") (quoting *United States v. Ron* [*475] *Pair Enterprises, Inc.*, 489 U.S. 235, 241, 103 L. Ed. 2d 290, 109 S. Ct. 1026 (1989) (internal quotations omitted); *Connecticut Nat'l Bank v. Germain* 503 U.S. 249, 254, 117 L. Ed. 2d 391, 112 S. Ct. 1146 (1992) ("When the words of a statute are unambiguous, then, this first cannon is also the last: 'judicial inquiry is complete.'") (citations omitted).

(i) *Settlement Payments*

A number of courts which have examined the meaning and legislative history of § 546(e) have concluded that the definition [**184] of settlement payment "defies plain meaning; to the contrary…it is circular and cryptic." *Zahn*, 218 B.R. at 675; *Brandt v. Hicks, Muse & Co., Inc. (In re Healthco Int'l)*, 195 B.R. 971, 983 (Bankr. D. Mass 1996) (the statutory definition of the term "is as opaque as it is circular"); *Wieboldt Stores, Inc. v. Schottenstein*, 131 B.R. 655, 663 (N.D. Ill. 1991). As one court put it, § 546(e) "essentially" provides that a settlement payment is a settlement payment…." *Zahn*, 218 B.R. at 675.

By way of guidance in ascertaining the meaning of "settlement payment," as the term relates to both § 546(e) and companion provisions in § 546(f), [44] Congress made clear that the provisions are to be defined with reference to the common understanding, practice and usage in the securities industry. First, § 546(e) specifies that the qualifying transfers consist of payments made "by or to" various participants in the trading of securities, specifically a commodity broker, forward contract merchant, stockbroker, financial institution, or securities clearing agency. *See* 11 U.S.C. § 546(e). Second, Section [**185] 741(8) itemizes several particular forms of settlement payments included in the definition. *See* 11 U.S.C. § 741(8). *See Kaiser II*, 952 F.2d at 1237; *Bevill, Bresler & Schulman Asset Management Corp. v. Spencer Sav. & Loan Ass'n (In re Bevill, Bresler & Schulman Asset Management Corp.)*, 878 F.2d 742, 751 (3d Cir. 1989). Further reflecting actual industry practice and definitional understanding, the Bankruptcy Code expressly extends its reach to cover several particular kinds of financial transactions which rely upon the concept of settlement payments. [45] *See Kaiser II*, 952 F.2d at 1239 n.9

[**186]

In ordinary language, "payment" refers to the "act of paying" or to the thing being paid. *Marriam-Websters Collegiate Dictionary* 853 (10th ed. 1998). "To pay" is defined as "1a: to make due return to for services rendered or property delivered …. [2b]: to discharge indebtedness for: settle …. [2c]: to make a disposal or transfer…." *Id.* The term "settlement" as commonly used in connection with purchases and sales in the securities trade refers to acts that occur at different stages of the process towards completion of the securities transaction. *See Kaiser Steel Corp v. Charles Schwab & Co., Inc.*, 913 F.2d 846, 849 (10th Cir. 1990) (herein "*Kaiser I*"). In *Kaiser I* the Tenth Circuit cites approvingly several industry sources that define the term in words that share a common element: the payments are made in contemplation of the completion of a securities trade. [46] *See id.*

[**187] [*476] The first aspect of the process, known as "street-side settlement", involves the relationship and associated actions between brokers and clearing agencies during the clearance and settlement of the trade. *See Kaiser II*, 952 F.2d at 1237. [47] In this context,

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[44] Section 546(f) pertains specifically to settlement payments made in connection with repurchase agreements. *See* 11 U.S.C. § 546(f).

[45] These transactions include: "securities contracts", *see* U.S.C. § 741(7); "repurchase agreements", *see* 11 U.S.C. § 101(47); "commodity contracts", *see* 11 U.S.C. § 761(4); "forward contracts", *see* 11 U.S.C. § 101(25); *see also Kaiser II*, 952 F.2d at 1239, n.9.

[46] *See, e.g.*, A. Pessin & J. Ross, Words of Wall Street: 2000 Investment Terms Defined 227 (1983); *accord* D. Brownstone & I. Franck, The VNR Investor's Dictionary 279 (1981.) ("finishing up of a transaction or group of transactions"); Group of Thirty, Clearance and Settlement Systems in the World's Securities Markets 86 (1989) ("the completion of a transaction wherein securities and corresponding funds are delivered and credited to the appropriate accounts"); New York Stock Exchange, Language of Investing Glossary 30 (1981) ("conclusion of a securities transaction when a customer pays a broker/dealer for securities purchased or delivers securities sold and receives from the broker the proceeds of a sale"); D. Scott, Wall Street Words 320 (1988) ("transfer of the security (for the seller) or cash (for the buyer) in order to complete a security transaction").

[47] This System depends on two corresponding sets of

brokers transmit the purchases and sales to the clearing entity, which on the date of the trade makes credit and debit entries in the accounts of its member brokers and institutions, and records and computes the obligations it has incurred for payment on the settlement date, which typically occurs within five days of trade date. *See id.* At this stage, "settlement payments" are regarded "payments made in discharge of a party's settlement obligations." *Id.* (*citing* Division of Market Regulation, Securities and Exchange Commission, *The October 1987 Market Break* at 10-5 (1988)); *see also* Oesterle, *Comment on the Harris Paper*, 74 Cornell L. Rev. 943, 944 (1989) ("Settlement payments refer to the final payment of funds between the clearinghouse [members] for trade[s] registered to a specific point in time.").

[**188] In another phase, settlement occurs between the broker and the customer. "Customer-side settlement" has been defined as "'conclusion of a securities transaction when a customer pays a broker/dealer for securities purchased or delivers securities sold and receives from the broker the proceeds of a sale.'" *Kaiser II*, 952 F.2d at 1238 (quoting New York Stock Exchange, *Language of Investing Glossary* 30 (1981)).

In several cases which have considered the issue, the Bankruptcy Code's definition of settlement payments has been characterized as extremely broad. The cases have extended or adapted the term to embrace various forms of payment that further the settlement process in different types of securities transactions. *See Lowenschuss v. Resorts Int'l, Inc. (In re Resorts Int'l, Inc.)*, 181 F.3d 505 (3d Cir. 1999) (payment for shares during a leveraged buyout); *cert. denied*, 528 U.S. 1021, 145 L. Ed. 2d 411, 120 S. Ct. 531 *Hamilton Taft & Co., v. Howard, Weil, Labouisse, Freidrichs Inc.*, 114 F.3d 991 (9th Cir. 1997) (reverse repurchase agreement between stockbroker and debtor); *Jonas v. Resolution Trust Corp. (In re Comark)*, 971 F.2d 322, 325-26 (9th Cir. 1992) [**189] (debtor's return to another party, upon cancellation of the [*477] transaction, of government securities serving as additional margin in a repurchase agreement); *Kaiser II*, 952 F.2d at 1235 (payments to shareholders for their stock in connection with a leveraged buyout); *Bevill*, 878 F.2d at 743 (transfers of federal government securities in connection with repurchase agreements by participant securities dealer to purchasers qualify as settlement payments under § 546(f)); *but see Wieboldt*, 131 B.R. at 664-65 (return of certain transfers made by debtor in a leveraged buyout held not settlement payments); *see also Healthco Int'l*, 195 B.R. at 982.

In giving "settlement payments" an expansive reading, the courts in these cases recognize that the securities industry encompasses a wide range and variety of transactions, representing investments of staggering proportions and entailing corresponding national economic implications. [48] These interests demand stability and certainty in settled transactions, and legal definitions adaptable to the usage, understanding and realities of the market. *See Integra Realty*, 198 B.R. at 357 n.1. [**190] To promote these aims, Congress adopted § 546(e) as an exception to the Trustee's avoidance powers for transactions that are not actually fraudulent as defined in § 548(a)(1)(A). The statute recognizes that if the pre-bankruptcy transactions of a securities broker-debtor could be readily reversed, confidence in the chain of guarantees upon which the functioning of the system depends would be undermined and the entire market could be threatened by serial bankruptcies. *See Zahn*, 218 B.R. at 676; *Wieboldt*, 131 B.R. at 664.

[**191] The legislative history of § 546(e) indicates that the provision was intended "to minimize the

guarantees of performance made by all the parties in the chain affirming that they will honor their obligations despite a default by another party in the system. The brokers guarantee to perform if their customers fail to do so, and the clearing agency guarantees to perform if the clearing members do not. *See Kaiser II*, 952 F.2d at 1238 n.4. These guarantees allow the parties to trade freely without concern over events occurring between trade date and settlement date. *See Zahn*, 218 B.R. at 675-76. *Wieboldt*, 131 B.R. at 664 (citing Neil M. Garfinkel, Note, *No way Out: Section 546(e) Is No Escape for the Public Shareholder of a Failed LBO*, 1991 Colum. Bus. L. Rev. 51, 61-63); *Bankruptcy of Commodity and Securities Brokers, 1981: Hearings Before the Subcomm. on Monopolicies and Commercial Law of the House Comm. on the Judiciary* 97th Cong. 301 (1981) (statement of Jack Nelson, President, National Securities Clearing Corporation).

[48] *See, e.g., Bevill*, 878 F.2d at 745, noting that the estimate daily volume of repurchase agreements transactions in 1983 amounted to several hundred billion dollars; during one week in 1988 it was approximately $ 600 billion. The record volume of stock exchange and over-the-counter trades during the week following the market crash of 1987 was estimated at $ 200 billion. The court also observed that the repurchase agreements market is used by the Federal reserve System to help execute monetary policy, that the investments serve to finance the national debt at the lowest possible cost, and that they are also attractive to private businesses and state and local governments. *See id.*

displacement caused in the commodities and securities markets in the event [of] a major bankruptcy affecting those industries." H. Rep. No. 97-420, at 1 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583. More specifically, Congress sought to prevent the "ripple effect" created by "the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected industry". *Id.; see also Bevill*, 878 F.2d at 747.

The intent to reach broadly to encompass all aspects of securities industry practices is manifested in the language of the statute. The definition of settlement payment in Section 741(8) specifically mentions different forms of payments, whether "preliminary", "partial", "interim", "on account", "final", "*or any other similar payment commonly used in the securities trade.*" 11 U.S.C. § 741(8) (emphasis added); *see Kaiser II*, 952 F.2d at 1237 ("The clear aim of the definition is to encompass all 'settlement payments' commonly used in the securities trade.") (citing *Kaiser I*, 913 F.2d at 848). [**192] The Third Circuit reflected this flexibility in *Bevill*, where it observed that a broad statutory definition is consistent with Congress' intent that "settlement payment"

> may be the deposit of cash by the purchaser or the deposit or transfer of the securities by the dealer, and that it includes transfers which are *normally regarded* [*478] *as part of the settlement process*, whether they occur on the trade date, the scheduled settlement day, or any other date in the settlement process *for the particular type of transaction at hand*.

Bevill, 878 F.2d at 752 (emphasis added).

Appellants, citing these authorities, fault the bankruptcy court's "elevation of policy over the application of § 546(e)", and contend that the court's approach violates the plain meaning of the rule. They insist that "it was the bankruptcy court's responsibility to apply § 546(e) as written". Appellants' Brief at 74.

This Court agrees with the bankruptcy court and the Trustee that § 546(e) does not apply here to rescue Appellants' Challenged Trades, and concludes that Judge Garrity, in rejecting Appellants' § 546(e) defense, was not wrong to look not solely to the text but [**193] to the policy and overall scheme underlying the statute.

Though the courts agree that the § 546(e) definition of "settlement payment" is to be read broadly, the term "is not boundless." *In re Kaiser Merger Litigation*, 168 B.R. 991, 1001 (D. Colo. 1994); *see also Integra Realty*, 198 B.R. at 358. And while it is axiomatic that where the legislative scheme is coherent and consistent the court need not inquire beyond the text of the statute, in cases where the plain language, even if literally applicable, would yield absurd results at odds with the statutory design, courts may look beyond the printed word to the law as a whole and its purposes and policy, so as to determine what particular legislative intent may apply. *See Massachusetts v. Morash*, 490 U.S. 107, 115, 104 L. Ed. 2d 98, 109 S. Ct. 1668 (1989) ("'in expounding a statute, we [are] not… guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and to its object and policy.'") (citing *Pilot Life Ins. Co. v. Dedeaux*, 481 U.S. 41, 51, 95 L. Ed. 2d 39, 107 S. Ct. 1549 (1987)).

This principle expresses an obvious corollary [**194] to the paramount canon of statutory interpretation. If the plain language of the text is the point of departure, another bedrock premise equally guides our path to statutory meaning. It is that the courts must bear in mind that in exercising its powers to write the laws, Congress's declared purpose is legislation, not lexicography; that the essence lawmakers infuse into statutes to serve as building blocks is not disembodied words but organic substance imbued with meaning and charged to an end. As one of our eminent jurists reminds us "statutes always have some purpose or object to accomplish, whose sympathetic and imaginative discovery is the surest guide to their meaning." *Cabell v. Markham*, 148 F.2d 737, 739 (2d Cir. 1945), (L. Hand, J.), *aff'd*, 326 U.S. 404, 90 L. Ed. 165, 66 S. Ct. 193 (1945).

Thus, in prospecting profoundly into words in search of the sense of particular legislation, the most bountiful ground is bound to occur at the juncture where plain language and the lawmakers' intent converge to manifest policy and foster stated aims. For this task to be most authoritative and fruitful at any point of genuine uncertainty, the inquiry cannot [**195] end in text, but in context. It must take account of the whole and not surrender purpose to literalness. *See Shell Oil Co. v. Iowa Dep't of Revenue*, 488 U.S. 19, 25, 109 S. Ct. 278, 102 L. Ed. 2d 186 (1988) ("The meaning of words depends on their context."); *McCarthy v. Bronson*, 500 U.S. 136, 139, 114 L. Ed. 2d 194, 111 S. Ct. 1737 (1991) ("Statutory language must always be read in its proper context."). As the Supreme Court has stated in connection with the Bankruptcy Code, "statutory construction, however, is a holistic endeavor. [*479] A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme…." *United Savings Ass'n of Texas v. Timbers of Inwood Forest Assoc., Ltd.*, 484 U.S. 365, 371, 98 L. Ed. 2d 740, 108 S. Ct. 626 (1988).

The dispute now before the Court entails a tension not uncommon between literal language and the whole design of the Bankruptcy Code, as well as between competing objectives of the statute. In § 546(e), Congress recognized that the unwinding of settled securities transactions could create an environment hostile to capital formation, engendering diminished investor confidence, as well as increased [**196] costs and volatility of transactions in capital markets. To that end, strong policy reasons favor a statutory reading of settlement payments that protects participants in the securities markets and promotes finality of securities transactions, as a counterbalance to safeguarding the interests of creditors. *See Integra Realty*, 198 B.R. at 357 n.1 (quoting from portions of a brief the SEC submitted in *Kaiser I*).

At the same time, the spirit that infuses the whole of SIPA and the Bankruptcy Code is Congress's determination, reflected in a trustee's avoidance powers under § 548 as well as SIPC Rule 300.503, that "a few individuals should not be allowed to benefit from transfers by an insolvent entity at the expense of the many. Rather, Congress intended equal shares of the bankruptcy estate for creditors of equal rank." *Jewel Recovery*, 196 B.R. 348, 352 (Bankr. N.D. Tex. 1996) (citing *Young v. Higbee Co.*, 324 U.S. 204, 210 n.8, 89 L. Ed. 890, 65 S. Ct. 594 (1945)).

Faced with the clash of interests inherent in these provisions, courts which have had occasion to interpret and apply § 546(e) have identified a number of considerations [**197] which may prove helpful and persuasive in deciding which Congressional intent should prevail, and which other vital legislative policy must yield. These factors may be instructive in determining whether the transfers at issue here qualify as "settlement payments" entitled to the protection of § 546(e).

The courts' considerations include whether: (1) the transactions have long settled by means of actual transfers of consideration, so that subsequent reversal of the trade may result in disruption of the securities industry, creating a potential chain reaction that could threaten collapse of the affected market (*see Kaiser II*, 952 F.2d at 1240-41; *Integra Realty*, 198 B.R. at 356-57); (2) consideration was paid out in exchange for the securities or property interest as part of settlement of the transaction (*see Kaiser I*, 913 F.2d at 850; *Integra Realty*, 198 B.R. at 360 [49] [**199]); (3) the transfer of cash or securities effected contemplates consummation of a securities transaction (*see Resorts Int'l*, 181 F.3d at 515 [50]; *Comark*, 971 F.2d at 326; *Kaiser I*, 913 F.2d at 849); [**198] (4) the transfers were made to financial intermediaries involved in the national clearance and settlement [*480] system (*see Kaiser I*, 913 F.2d at 849; [51] *Wieboldt*, 131 B.R. at 664-65); (5) the transaction implicated participants in the system of intermediaries and guarantees which characterize the clearing and settlement process of public markets and therefore would create the potential for adverse impacts on the functioning of the securities market if any of those guarantees in the chain were invoked (*see Zahn*, 218 B.R. at 676; *Jewel Recovery*, 196 B.R. at 352; *Healthco Int'l*, 195 B.R. at 983; *Wieboldt*, 131 B.R. at 665-65).

Taking account of the language of § 546(e) in the light of these considerations, this Court affirms the bankruptcy court's determination that § 546(e) does not apply to protect the Challenged Trades from the Trustee's avoidance power under § 548(a)(1)(B). The Court concludes that (1) the transfers Appellants rely upon to enforce their Challenged Trades do not satisfy the [**200] criteria defining "margin payments" or "settlement payments" and (2) the application of § 546(e) to the circumstances present in this case would be inconsistent with the overall scheme of the

[49] The court in *Integra Realty* quotes from the Final Report of the Securities and Exchange Commission on the Practice of Recording the Ownership of Securities in the records of the Issuer in other than the Name of the Beneficial Owner of Such Securities, pursuant to Section 12(m) of the Securities Exchange Act of 1934 at 9, n.1 (December 3, 1976), which states that "clearance and settlement of securities encompasses the process by which parties to a transaction exchange money and securities." *See* 198 B.R. at 360 n.4.

[50] The *Resorts Int'l* court states that in the securities industry, a settlement payment is generally the transfer of cash or securities made to complete a securities transaction. *See id.*

[51] *But see Munford v. Valuation Research Corp.*, 98 F.3d 604, 610 (11th Cir. 1996) (holding § 546(e) not applicable to payments by a financial institution to shareholders in an LBO because the bank served only as an intermediary or conduit and never acquired a beneficial interest in either the funds or the shares); *cf. Resorts Int'l*, 181 F.3d at 516-17 (taking issue with *Munford's* standard that the transferee of the payment must acquire a beneficial interest in the securities or funds).

Bankruptcy Code and would substantially impede the fair and effective operation of SIPA. *See Charisma Sec.*, 506 F.2d at 1195.

As an initial matter, the Court does not need to reach the parties' dispute as to whether, as the Trustee holds, § 546(e)'s reference to "transfer" encompasses only actual movements of cash and securities and not incurrence of obligations, or whether, as Appellants' contend, the definition of "transfer" contained in § 101(54) is broad enough to encompass the various phases of the clearance and settlement process of securities transactions through which property or "an interest in property" passes that do not necessarily entail actual conveyance of cash or securities. *See* 11 U.S.C. § 101(54). [52] Regardless of how broadly or narrowly the term is defined, this Court is persuaded that the transfers which Appellants seek to enforce against Adler either did not constitute qualifying "payments" or did not contemplate consummation [**201] of a bona fide securities "settlement" in the relevant sense of these words.

The bankruptcy court found that none of the Appellants had sufficient funds at Adler to pay for the Blue Chips. Thus, with the exception of whatever value may be ascribed to the proceeds from the sale of Appellants' House Stocks, the only other transfer or payment Appellants count on to complete their transactions are the "purchase" [**202] payments Hanover, by means of automatic entries on Adler's books, credited to its customers' accounts and simultaneously debited from its proprietary account. The bankruptcy court, however, characterized Appellants' House [*481] Stocks as "practically worthless" (*Decision*, 247 B.R. at 106) and found these securities constituted but a fraction of the purchase price of the Blue Chips. To create a semblance on paper that its proprietary account was replenished with cash sufficient to pay for its House Stocks purchases, Hanover executed fake purchases of House Stocks as well as fake Short Sales of Blue Chips. However, because of Hanover's insolvency at all times during the Final Week and its inability and lack of intent to pay for those acquisitions, its reason for proceeding with these transactions, as the bankruptcy court determined, was to defraud Adler and its creditors.

Accordingly, the "payments" Hanover, acting as Appellants' agents, entered into Appellants' accounts and obligated Adler to deliver upon were not posted as elements of trades that contemplated a settlement of the transactions in the ordinary course of business. Rather, they were actually integral components [**203] of Hanover's criminal conduct and other wrongful acts committed to "enhance the SIPC claims of the Claimants, not to have the trades performed." *Decision*, 247 B.R. at 104. To this extent, these portions of phantom fraudulent payments Appellants seek to apply to their purchase of Blue Chips could not be considered as contemplating a normal "completion of a securities transaction" as commonly understood in the securities industry. *Kaiser I*, 913 F.2d at 849; *see also Comark*, 971 F.2d at 325; *Bevill*, 878 F.2d at 752. While the statutory definition of settlement payment may be obscure and elusive, one clear policy purpose Congress reflected was to "protect ordinary course of business transfers related to the purchase or sale of securities." *Healthco Int'l*, 195 B.R. at 983 (citing H.R. Rep. No. 595, at 392 (1977).

To the degree the definition of "settlement payments" Congress drafted to govern application of § 546(e) employs as a reference point transfers in the ordinary course of business "normally regarded [in the securities trade] as part of the settlement process" for the particular transaction ([**204] *see Bevill*, 878 F.2d at 752), the form of "payments" so steeped in fraud that Appellants here rely upon can hardly be deemed so "normally regarded". *Id.; see also Healthco Int'l*, 195 B.R. at 983. An inherent aspect of these payments encompassed, as elements of Hanover's "integrated scheme", transfers specifically designed to undermine the very statutory design Congress enacted to protect the securities industry.

Appellants argue that their transactions satisfy the definition of "settlement payments" because "Adler delivered the cash to the Appellants by debiting it out of Hanover's account and into theirs." Appellants' Reply at 24 (citing *Decision*, 247 B.R. at 82). Appellants overlook, however, whatever "cash" Adler "delivered" to Appellants it transferred only because Hanover made fraudulent entries into its customers' accounts that included Hanover's manipulated prices, and that Adler could not debit any "cash" out of Hanover's account

[52] The Court notes that as regards one issue that may bear upon this argument the circuit courts have expressed disagreement. One view holds that a transfer may include clearing through parties who serve only as intermediaries or conduits and do not acquire a beneficial interest in the property involved in the transaction, and that such transfers constitute settlement payments protected by § 546(e). *See e.g. Kaiser II*, 952 F.2d at 1236 (payments to intermediary brokers as part of a leveraged buyout). Another circuit took a contrary position. *See Munford*, 98 F.3d at 610.

because Hanover, then insolvent, had no "cash" it could deliver. Thus, Hanover knew that any "cash" it booked into its customers' accounts as part of the Challenged Trades' settlement had to derive, [**205] if at all, by way of its fraud upon Adler and SIPC. Consequently, "payments" for the trades Hanover mechanically posted as transfers by Adler for the benefit of selected customers could no more be classified as "normal" in securities trades than rubber checks could be commonly regarded as acceptable means of payment in the banking industry. [*482]

Second, for the same reasons, the payments Hanover booked into Appellants' accounts at Adler did not constitute transfers paid out as consideration in a bona fide exchange for the House Stocks it purported to buy from Appellants, or for the Blue Chips it supposedly purchased on their behalf. In fact, Hanover had insufficient assets to exchange during the Final Week. Looking at the transaction as a whole, there is no evidence, as the bankruptcy court found, that what Hanover, acting as Appellants' agent, contemplated would proceed to settlement as to each trade was a bona fide, bargained-for exchange or negotiated contract rather than a consummated fraud against Adler and its creditors.

Hanover's various schemes, which encompassed multiple deceptions and manipulations designed to defraud Adler, could not be considered part of an arms-length "exchange" [**206] of consideration. Were the "payments" in question to be recognized as sufficient for Appellants to enforce the Challenged Trades, the bulk of the value Adler would exchange for actual cash or Blue Chip securities it would be obligated to transfer to Appellants' accounts would be the "cash" Hanover credited to its own proprietary account. These credits represented customer purchases of House Stocks that were fabricated and booked at Hanover's manipulated prices. *See Integra Realty*, 198 B.R. at 360 (examining a unilateral transfer of securities to shareholders, the court observed: "There was not really an exchange, and certainly, no consideration was given by the recipients for the exchange. The Court is not inclined to treat any delivery of stock to complete a distribution as a settlement payment.").

Third, because the "payments" Appellants rely upon to validate their Blue Chips purchases primarily represent Hanover's phony book entries into Adler's books, there were no actually completed transfers of cash and securities. The Blue Chips were never delivered, and the trades involving them never settled. For these reasons, avoiding the Challenged Trades would not entail [**207] unwinding trades settled long ago that might create a threat of disruption to the affected market. *See Kaiser I*, 952 F.2d at 1240-41. Similarly, the Court finds no evidence on the record indicating that any effects of reversing the Challenged Trades would spill over beyond Adler into the securities industry to threaten the "ripple effect" on other brokers and participants in the system that concerned Congress when it enacted § 546(e). *See Bevill Bressler*, 878 F.2d at 747; *Integra Realty*, 198 B.R. at 360; *Jewel Recovery*, 196 B.R. at 352.

Insofar as Appellants contend they made qualifying settlement payments that were "partial" or "on account" as represented by the House Stocks legitimately in their accounts, the argument seeks to divorce aspects of Appellants' trades from Hanover's integral deceitful design that included manipulated prices sustained by fictitious transactions. The Court rejected this argument above. In response to Appellants' disclaimer that Hanover did not act as its authorized agent in connection with these transactions, the bankruptcy court determined otherwise in a conclusion this Court has endorsed. [**208] *See* discussion *supra* Part III.C.1.

Finally, this Court concurs with the policy concerns Judge Garrity articulated. Although no other brokers beyond Adler may be directly affected by the Challenged Trades, protecting the claims of a few customers at the expense of the many other creditors under the circumstances surrounding this case would not inspire stability and confidence in the capital markets. It would give a blessing to an introducing [*483] broker's massive, integrated scheme specifically intended to defraud its clearing house and SIPC and to benefit selected customers. The effect of enforcing these involuntary transfers against the debtor, for the benefit of some of those customers, would be to diminish the assets available for equitable distribution to all other similarly situated creditors. *See Jewel Recovery*, 196 B.R. at 352.

(ii) *Margin Payments*

This Court concludes that essentially the same reasoning that would preclude the application of § 546(e) to protect the transfers in question as "settlement payments" would equally bar use of the statute to exempt the same fraud-tainted transfers as "margin payments." Like "settlement payments", the Bankruptcy [**209] Code defines "margin payments" by reference to what is commonly regarded as such transfers in the securities trade, including a general catchall to embrace a payment "that secures an obligation of a participant in a securities clearing agency." 11 U.S.C. § 741(5). [53]

Appellants contend that their House Stocks and their cash proceeds "secured payment to Adler", a securities clearing agency, and that Adler similarly held this property "as security for the Appellants' obligation to pay for the Blue Chip Buys." Appellants' Brief at 74. However, the participant in a securities clearing agency referred to in § [**210] 741(5) is Adler, as clearing house, not Appellants as customers. Thus, the "obligation" that § 741(5) defines as being secured by a margin payment must be that "of" Adler to perform in a manner that implicates its participation in a clearing agency, rather than that of Appellants as customers to pay Adler.

In this case, the obligations Adler incurred to perform the Challenged Trades on behalf of Appellants were those created by Hanover's book entries of debits and credits for securities purchases at manipulated prices it quoted and in amounts Hanover knew it could not pay and thus also knew Adler would be obligated to pay. Although the bankruptcy court found that Adler regularly monitored Hanover's accounts, it also noted that Adler did not have the ability to do so on a real-time basis. *See Decision*, 247 B.R. at 90, 121. Thus, Adler was not in a position under the circumstances to determine immediately the adequacy or reality of the assets available in its Hanover-related accounts as margin to secure Adler's obligation to the clearing agency, thereby placing Adler and the system at risk of loss. As a consequence, under Appellants' theory of margin payments, Adler's [**211] determinations regarding transfers to secure its obligations to the clearing agency would be made not by Adler, but by Hanover's unilateral fraudulent entries on Adler's books. By these means, Adler in effect would be obligated to become a participant and to aid in perpetrating a fraud upon itself devised by its introducing broker.

The Court concludes that, under the circumstances established by the evidence the bankruptcy court cited in this case, Appellants' argument must fail. To classify the transfers Appellants characterize as "margin payments," thus qualifying for the protection of § 546(e) and entitling Appellants to enforce the Challenged Trades against Adler, would run counter to the [*484] common understanding of margin payments in the ordinary course of the securities trade and conflict with essential purposes of the Bankruptcy Code and SIPA.

(iii) *The Holistic Statutory Framework*

It is true, as Appellants stress, that as regards margin or settlement payments, § 546(e) specifically preserves the bankruptcy trustee's power to avoid transactions as fraudulent conveyances only to the extent the claim is brought pursuant to § 548(a)(1)(A), which by its terms applies only [**212] to transfers by the debtor with actual intent to defraud creditors. From § 546(e)'s recognition of this exception, Appellants deduce that the trustee's remedy must be exclusive, and that under SIPA once a claim for cash or securities satisfies the literal requirements of SIPC Rules 300.501 or 502, the transaction must be honored. *See* Appellants' Brief at 70, 77; Appellants' Reply at 25, 29.

Under this theory, § 546(e) would insulate from avoidance by the trustee, under any other applicable law incorporated by § 544(b) [54], any property transfers in connection with execution of a securities trade. In other words, if the transaction does not qualify as a fraudulent conveyance by a debtor, the trustee is barred from challenging its validity or enforceability under any other theory, even if the transaction is otherwise permeated with fraud that is not directly attributable to the debtor or to the claimant.

[**213] The conclusion Appellants draw does not follow. It rests on a flawed syllogism that omits due recognition of a vital link in the statutory design, and represents an untenably constraining interpretation of the overall framework reflected in the interconnections

[53] Section 741(5)'s complete definition of "margin payment" states:

> Payment or deposit of cash, a security, or other property, that is commonly known to the securities trade as original margin, initial margin, maintenance margin, or variation margin, or as a mark-to- market payment, or that secures an obligation of a participant in a securities clearing agency.

Id.

[54] Section 544(b) authorizes the trustee to "avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title." 11 U.S.C. § 544(b); *see also* 15 U.S.C. § 78fff(b), which makes chapters 1, 3 and 5 and subchapters I and II of chapter 7 of title 11 applicable to SIPA proceedings.

among the Bankruptcy Code, SIPA and the SIPC Rules. First, the Bankruptcy Code applies to SIPA liquidations only to the extent it is consistent with SIPA. *See* 15 U.S.C. § 78fff(b).

Second, Appellants' argument invokes Rules 300.501 and 502, while essentially overlooking or discounting the effect of Rule 300.503. The latter provision states unequivocally that nothing in the Series 500 Rules shall be construed to limit the trustee's rights in a SIPA proceeding to avoid any securities transaction as "fraudulent, preferential, *or otherwise voidable* under applicable law." 17 C.F.R. § 300.503 (emphasis added). This Rule, juxtaposed following Rules 501 and 502, must be viewed as serving a purpose of limitation, as a qualifying proviso, and not an appendage or nugatory afterthought.

Rule 503's reference to "under applicable law" indicates that the avoidance power reserved [**214] extends beyond SIPA and the Bankruptcy Code, and thus could incorporate relevant fraud avoidance actions recognized by other federal and state laws. *See Ensminger I*, 218 B.R. at 702 (reference to "other applicable law" in § 544(b) incorporates "any applicable law, including, *but not limited to*, SIPA, the Bankruptcy Code, and New York's Debtor and Creditor Law") (emphasis added). Moreover, the language "fraudulent *or* otherwise voidable", framed as it is in the alternative, clearly signifies an intent to encompass avoidance actions predicated upon legal theories grounded not solely on fraudulent conveyances by a [*485] debtor but extending as well to principles rendering the transactions "otherwise voidable", as, for example, under common law rules regarding rescission or unenforceability of contracts entered into in violation of statutes.

Accordingly, where, as in the instant case, the requirements of § 548(a)(1)(A) may not be satisfied -- because the debtor itself may have made no intentionally fraudulent transfer, but nonetheless was itself manifestly the victim of deliberate deceit in connection with the particular transaction -- nothing in the language, legislative [**215] history or statutory intent of § 546(e) may reasonably be construed to countenance the use of the stockholder defense as Appellants propose. The effect of this theory would be to apply the statute, not as a shield to protect truly bona fide trades of parties uninvolved in any misconduct, but as a device employed by the perpetrator, and/or its principals or beneficiaries, to affirm and enforce a fraud the existence of which depends, as an integral component of the scheme, upon payments that are sought to be immunized as "settlement" or "margin" payments. Courts confronted with claims to extend the application of § 546(e) so as to give effect to fraudulent schemes have rejected the effort. *See Wider v. Wootton*, 907 F.2d 570, 573 (5th cir. 1990) (asserting that the court "will not implicitly authorize fraudulent business practices through an unjustified extension of the stockholder defense").

D. *AVOIDANCE OF TRANSFERS PURSUANT TO § 544(b) AND NEW YORK DEBTOR AND CREDIT LAW*

Section 544(b) of the Bankruptcy Code empowers the trustee to "avoid any transfer of interests of the debtor in property or any obligation incurred by the debtor that is voidable under [**216] applicable law by a creditor holding an [allowed] unsecured claim" against the debtor. U.S.C. § 544(b). "Applicable law" for these purposes in the instant case would include the New York Debtor and Creditor Law, the relevant portions of which are contained in. §§ 270-81. *See* N.Y. Debt. & Cred. Law §§ 270-81 (McKinney 1990). The statute contains avoidance provisions comparable to those the Bankruptcy Code authorizes, enabling creditors to avoid transfers that are actually fraudulent (*see id.*, § 276) or constructively fraudulent. *See id.*, §§ 273-74; *see also Harvard Knitwear, Inc.*, 193 B.R. 389, 392 (E.D.N.Y. 1996).

The bankruptcy court noted that New York's Debtor and Creditor Law and § 548 of the Bankruptcy Code "devolve from the same source, are founded on the same principles and are designed to effectuate the same purposes." *Decision*, 247 B.R. at 116 (*citing* the Statute of Elizabeth, 13 Eliz., ch. 5 (1571); 5 *Collier*, PP 548.01[2], at 548-8, 548.LH[2] at p. 548-89). Accordingly, the court held that the same intent imputation doctrine it had employed in connection with its determination of the Trustee's § 548(a)(1)(A) [**217] avoidance claim applied under New York law as well, and that on the same basis that the Trustee could avoid the Challenged Trades under § 548(a)(1)(A) he is also entitled to judgment pursuant to §§ 273-74 of the New York Debtor and Creditor Law. *See id.*

For the reasons described above, to the degree that the New York Debtor and Creditor Law's avoidance provisions are coextensive with and grounded on the same substantive principles and purposes as § 548, this Court concludes that the Trustee may avoid the Challenged Trades as constructively fraudulent under §§ 273-74, but not as actually fraudulent [*486] under §

276 of the New York Debtor and Creditor Law.

In part, the bankruptcy court found support for the Trustee's position in *Stochastic Decisions, Inc., v. DiDomenico*, 995 F.2d 1158, 1172 (2d Cir.), *cert. denied*, 510 U.S. 945, 126 L. Ed. 2d 334, 114 S. Ct. 385 (1993). This Court does not read in *Stochastic* the extension of the intent imputation doctrine that would be necessary in this case to find actual fraudulent intent on Adler's part. That case, which primarily involved an action under the Racketeer Influenced and Corrupt Organizations [**218] Act, 18 U.S.C. § 1961, did not deal with the issue at hand in any meaningful way.

The very brief mention in *Stochastic* of the New York Debtor and Creditor Law as construed by the New York Court of Appeals that is cited and relied upon by the bankruptcy court referred to "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." *Id.* (emphasis added). This Court does not read this language to clarify the specific issue relating to the scope of intent imputation under the domination or control doctrine that the Court found insufficiently settled in connection with § 548(a)(1)(A). *See* discussion, *supra*. Part III.C.1.b.

E. *RESCISSION OF CONTRACTS UNDER NON-BANKRUPTCY LAWS*

The bankruptcy court upheld the Trustee's determinations to rescind the Challenged Trades as fraudulent transfers under New York common law and as illegal contracts under federal and state securities laws. This Court affirms the bankruptcy court's rulings on these grounds.

1. *Common Law Fraud*

Under New York law, an action for common [**219] law fraud requires a plaintiff to establish, by clear and convincing evidence, each of the following elements: that the defendant (1) made a material, false statement; (2) knowing that the representation was false; (3) acting with intent to defraud; and that plaintiff (4) reasonably relied on the false representation; and (5) suffered damage proximately caused by the defendant's actions. *See Turtur v. Rothschild Registry Int'l, Inc.*, 26 F.3d 304, 310 (2d Cir. 1994); *Vermeer Owners, Inc. v. Guterman*, 78 N.Y.2d 1114, 585 N.E.2d 377, 378, 578 N.Y.S.2d 128 (N.Y. 1991). The remedies available in an action challenging a contract procured by fraud or false representation include rescission and cancellation. *See Davis v. William Rosenzweig Realty Operating Co.*, 192 N.Y. 128, 84 N.E. 943, 944 (N.Y. 1908); *Big Apple Car, Inc. v. City of New York*, 204 A.D.2d 109, 611 N.Y.S.2d 533, 534 (N.Y. App. Div. 1st Dept. 1994).

a. *The Hanover's Misrepresentations*

The bankruptcy court found that, through its direct computer links with Adler, Hanover made the following representations to Adler: (a) customers were really purchasing [**220] and intended to pay for $ 45.1 million in House Stocks; (b) Hanover was going to pay for the $ 22 million in securities that remained in its proprietary accounts; (c) the prices for the Fake Buys represented the true market price real customers were willing to pay for the House Stocks; and (d) there were assets available from Hanover's customers to pay for the Fake Buys and Fake Short Sales that Hanover booked in the Final Week. *See Decision*, 247 B.R. at 120-21.

As the bankruptcy court had determined in connection with its analysis of the Trustee's claims under § 548, Hanover knew at [*487] the time it made these representations that they were false and that Hanover uttered them to deceive Adler into clearing the Challenged Trades. *See id.* The court also found that Adler reasonably relied on Hanover's misrepresentations and was damaged as a consequence by incurring obligations to deliver cash and Blue Chips in exchange for the House Stocks Claimants sold to Hanover. *See id.* at 125. Finally, the court found that in making these representations Hanover acted as Claimants' agent. *See id.* at 121 n.95.

Appellants do not dispute that Hanover [**221] explicitly or implicitly made the representations the bankruptcy court found to be fraudulent. *See* Appellants' Brief at 84. They take issue only with the court's conclusion that Hanover acted as their agent in making those representations and with the court's treatment of the reliance issue. They contend that the court did not determine that Adler relied on the Hanover's false statements and that in fact the trial record established conclusively that Adler did not rely on Hanover's ability to pay for its purchases of House Stocks, or on the legitimacy of the Fake Buys and Fake Short Sales. *See id.*

b. *The Bankruptcy Court's Rulings and Factual Basis*

In assessing the reasonable reliance elements, the bankruptcy court reviewed the trial record at length and reported and relied upon the following factual findings:

. While Adler supervised the trading accounts of Hanover and other corresponding brokers on a daily basis, it could not do so on a real-time basis because trades were not reflected in Adler's books and records until the morning after the trades were made. *See Decision*, 247 B.R. at 121.

. For approximately two weeks before the Hanover closed, [**222] Adler was providing regular information to NASD and the NYSE about Hanover's financial condition and trading in House Stocks. *See id.* A team of NYSE and NASD regulators appeared daily on Adler's premises to monitor trading by Adler and Hanover and to ensure that they were in capital compliance. *See id.*

. Adler was aware, based on customer complaints during the period from early December 1994 to late January 1995, that Hanover was being accused of improprieties and that it was the subject of an SEC investigation for securities fraud. *See id.* at 121-22.

. Until the day Hanover closed, the evidence that the NASD had received indicated to the NASD that the Hanover was in capital compliance; in fact, the NASD reported to NYSE on February 23, 1995, the day before Hanover closed, that the firm was in capital compliance. *See id.*

. Adler had reason to be believe that in late January 1995, Hanover was or would soon be out of capital, and for that reason demanded a $ 10 million capital infusion from Hanover. *See id.*

. There was no evidence to suggest that Adler knew that Hanover was in fact out of capital during the Final Week. *See id.*

[**223] . Shortly before Adler closed on February 26, 1995, Adler's shareholders infused $ 1 million in capital into Adler in an effort to protect it from a net capital deficiency caused by Hanover's failure, evidencing that Adler had no concept of the breadth of Hanover's or of Adler's financial condition. *See id.*

. Adler personnel, in deposition testimony, flatly denied knowledge of Hanover's fraudulent scheme. *See id.*

[*488] . Although Adler could have terminated its computer link with Hanover at any time, the evidence does not reflect that Adler should have done so based upon the knowledge that Adler possessed. *See id.* at 122.

. Despite Adler's efforts, Hanover successfully concealed the nature and extent of its fraudulent scheme from Adler and the regulators. *See id.* at 124.

On these facts based on trial testimony and other evidence on the record, the bankruptcy court concluded that, whatever knowledge Adler had of Hanover's trading irregularities or financial condition, "Adler had no inkling of the true extent of Hanover's troubles or that it was engaging in fraudulent trading in an effort to stay in business." *Id.* at 123. [**224] The court thus specifically found that "Adler reasonably relied on Hanover's false representations." *Id.* at 124.

Appellants' challenge of the bankruptcy court's findings and conclusions contends that (1) the court did not find by clear and convincing evidence that Hanover's false representations constituted a substantial factor in Hanover's decision to clear and settle Appellants' trades; (2) Adler not only did not rely on Hanover's misrepresentations, it knew them to be false and consciously chose to continue to clear and settle trades for Hanover, such knowledge precluding a determination of reliance; (3) Adler knew Hanover could not pay for its purchases of House Stocks; (4) Adler knew Hanover's Fake Buys and Fake Short Sales were not authorized; (5) even if Adler did believe and rely on Hanover's false representations, its reliance was not justified because the truth was staring Adler in the face and Adler chose to look the other way; and (6) because Adler guaranteed Hanover's trades on behalf of Appellants, the Trustee cannot rescind them on the basis of Hanover's frauds.

These arguments essentially represent a frontal attack on the bankruptcy court's factual [**225] findings, challenging the judge's assessment of trial testimony and other evidence of record. In each case, Appellants read the same record and reach different factual conclusions from it.

On this appeal the applicable standard of review is clear error, even if at trial on the merits a heightened standard, such as clear and convincing evidence, may have applied. *See United States v. Costello*, 275 F.2d 355, 357 (2d Cir. 1960). Whatever the standard, the reviewing court is obligated to give the trial court due deference and cannot reverse where it finds that the trial court, reviewing conflicting versions of evidence, decides to credit that offered by the party it determines to be more credible or convincing. *See Anderson*, 470 U.S. at 573-74 (Where there are two permissible views of the evidence, the fact finder's choice between them cannot be clearly erroneous."); *EEOC v. Local 638*, 81 F.3d 1162, 1174 (2d Cir. 1996).

The Court has reviewed the record and Judge Garrity's exhaustive analysis of the evidence. On this basis, this Court upholds the bankruptcy court's findings as "plausible in light of the record in its entirety." *Anderson*, 470 U.S. at 573-74. [**226] The Court is not persuaded that Appellants have established clear error in the bankruptcy court's review of the record or in its factual findings. Many of these determinations necessarily rest on the trial court's assessments of credibility of given witnesses, what material to credit and how much weight to assign to particular testimony or documents. [55]

[*489] Appellants' quarrels with regard to these issues rest substantially on matters of judgment, on their being unable to come to terms with factual determinations the [**227] trial judge reached that differ from their own subjective reading of the evidence. At best, Appellants what assert is that there is another permissible reading of the record. To this extent, this Court remains unconvinced by Appellants' claims of error. The Court also finds the bankruptcy court's conclusions of law consistent with applicable rules and precedent.

c. *Appellants' Responsibility*

First, with regard to Appellants' responsibility for Hanover's representations acting as Appellants' agent, the relevant factual issues and legal principles were already considered above in the discussion of the question as it relates to application of the Bankruptcy Code's fraudulent conveyance provisions. *See* Section , *supra*. The Court incorporates and reiterates its conclusion upholding the bankruptcy court's corresponding determination that in making the representations here at issue Hanover acted as Appellants' authorized agent.

d. *Reasonable Reliance*

Next, the Court addresses the common law issue in dispute. The standard of reasonable reliance and due diligence applied under New York Law is articulated in *Mallis v. Bankers Trust Co.*, 615 F.2d 68, 80 (2d Cir. 1980). [**228] In fraud actions, a plaintiff need not establish due diligence except in cases "in which plaintiff was on guard or practically faced with the facts." *Id.; see also Lazard Freres & Co. v. Protective Life Ins. Co.*, 108 F.3d 1531, 1542 (2d Cir.), *cert. denied*, 522 U.S. 864, 139 L. Ed. 2d 112, 118 S. Ct. 169 (1997); *Manufacturers Hanover Trust Co. v. Drysdale Sec., Inc.*, 801 F.2d 13, 18, 23-25 (2d cir. 1986), *cert. denied*, 479 U.S. 1066 (1987).

Reliance is a distinct element of fraud. *See* Restatement (Second) Torts § 537 (1977); *see also id.*, § 546 ("Reliance is to fraud what proximate cause is to negligence; that is to say, fraud and injury must bear the relation of cause and effect"). A plaintiff asserting fraud may rely on a representation without undertaking to investigate if the representation related to matters uniquely within the defendant's knowledge and plaintiff has no independent means available to ascertain the truth. *See Lazard Freres*, 108 F.3d at 1542 (If plaintiff "has the means of knowing, by the exercise of ordinary intelligence, the truth, or the real quality of the subject [**229] of the representation, he must make use of those means, or he will not be heard to complain that he was induced to enter into a transaction by misrepresentations."); Restatement (Second) of Torts § 540 ("The recipient of a fraudulent misrepresentation of fact is justified in relying upon its truth, although he might have ascertained the falsity of the representation had he made an investigation.") *see also Mallis*, 615 F.2d at 80-81. While reliance must be justifiable, mere negligent failure to investigate adequately is insufficient to bar a claim of fraud. *See Albert v. Title Guar. & Trust Co.*, 277 N.Y. 421, 14 N.E.2d 625 (N.Y. 1938) ("It is no excuse for a culpable misrepresentation that means of proving it were at hand.").

Applying these standards here, the bankruptcy court, following its lengthy [*490] recitation of the relevant evidence, specifically concluded that "Adler reasonably relied on Hanover's false representations. It was damaged as a consequence. . . ." *Decision*, 247 B.R. at 124. These findings explicitly express the three necessary factual elements pertaining to reliance: (1) establishment of the presence of reliance; (2) demonstration [**230] that the reliance was reasonable; and (3) the cause and effect relation between reliance and the injury alleged. The court's determination that Adler was "damaged *as a consequence*" of Hanover's fraud, immediately following its finding of reasonable reliance, cannot be fairly read as other than a reflection

[55] In reviewing the dispute over whether Adler had guaranteed Hanover's trades, for example, the court, referring to evidence offered by Appellants' expert, observes that " we are unpersuaded by Lowry's report and the testimony he gave during the trial on this issue." *Decision*, 247 B.R. at 119. Instead, the court credits the testimony of the Trustee's expert: "We find Mr. Press' testimony to be more persuasive and in keeping with the plain language of the Clearing Agreement." *Id.*

of the causal relation -- "consequence" -- between the reliance and the injury -- the effect -- Adler suffered on account of it.

The evidentiary record sufficiently sustains the bankruptcy court's finding, made after trial and an exhaustive review of the facts, that Adler's knowledge "does not even remotely approach what is tantamount to complicity in Hanover's fraudulent scheme, or even acquiescence in Hanover's actions as a calculated risk with a profit motive." *Decision*, 247 B.R. at 122-23. This conclusion is supported by the deposition testimony of Edward Cohan, Adler's Chairman and Chief Executive Officer, who testified that it was not until the evening of February 23, 1995 that he came to believe Hanover was engaged in illegal conduct through bribery of Short Sellers, actions he immediately reported to the NYSE. *See id.* at 122 (citing [**231] Cohan Dep. Tr. 62:18; 166:12-15; 182:4-183:9; 185:21-187:4; 206:8-207-8). William Giordano, Adler's second in command confirmed Cohan's statements concerning Adler's knowledge of Hanover's conduct. *See id.* (citing W. Giordano Dep. Tr. 10:16-18; 16:7-11; 34:17-35). To the same effect, the Trustee's expert testified at trial that Hanover's fraud and true financial condition were not apparent to Adler. *See id.* at 124.

By contrast, Appellants quote various statements from the record purportedly contradicting or casting doubt on the testimony the bankruptcy court relied upon, and demonstrating the extent of what Adler knew or should have known about Hanover's financial troubles and illegal activities. *See* Appellants' Brief at 87-99. This Court offers three responses to Appellants' contention. First, to the degree Appellants' case rests upon possible doubts reflected in the testimony of witnesses, or on conflicting interpretations of the record, the trier of fact is in the best position to assess the probity of witnesses and to assign their statements and related proof appropriate relevance, credibility and weight. *See Anderson*, 470 U.S. at 573-74. [**232] Upon review of such conflicts, this Court must accord due deference to the trial court's findings of fact and to its resolution of conflicting testimony. It bears noting on this point that as regards the standard of review of the bankruptcy court's factual findings, the Bankruptcy Rules do not distinguish between oral and documentary evidence. *See* Fed. R. Bankr. P. 8013. Taking account of these considerations, the Court finds sufficient evidence to support the bankruptcy court's findings and is not persuaded that Judge Garrity's factual determinations on the various points Appellants contest are clearly erroneous.

Second, there is a significant difference, as the bankruptcy court acknowledged, between, on the one hand, Adler's state of knowledge and reasonable suspicions about Hanover's financial difficulties and irregularities, and, on the other, both Adler's total appreciation of the full breadth of Hanover's massive frauds and other criminal conduct, as well as its conscious and affirmative complicity in those [*491] unlawful actions. This distinction expresses the substantive contrast, which amounts to more than just a matter of degree, in dividing mere negligence from recklessness [**233] or actual intentional misconduct. *See, e.g., Daniels v. Williams*, 474 U.S. 327, 334, 88 L. Ed. 2d 662, 106 S. Ct. 662 (1986).

Third, Appellants' theory is tantamount to an accusation that Adler, in pursuit of its own profit motive, knowingly or recklessly, aided Hanover's frauds or deliberately chose to look the other way. *See* Appellants' Brief at 86. This argument poses a dilemma which should give Appellants grounds for pause, as it does to the Court. For, were the Court to adopt the predicate of Appellants' claim, the implications to their case would be severe. In essence, Appellants urge the Court to accept that Adler, with full knowledge and in conscious or reckless disregard of the facts and for its own gain, chose to facilitate Hanover's fraud. Were the Court to so determine, it could hold that Adler's conduct was sufficiently conscious or reckless that Adler could be deemed to have possessed the actual intent to defraud its creditors. In that event, Adler's transfers of property in connection with the Challenged Trades would satisfy the elements for avoidance of fraudulent conveyances pursuant to § 548(a)(1)(A) of the Bankruptcy Code and its companion [**234] state law provision, New York Debtor and Creditor Law § 276. *See Personnel Adm'r of Massachusetts v. Feeney*, 442 U.S. 256, 278, 60 L. Ed. 2d 870, 99 S. Ct. 2282 (1979) (expressing "the presumption, common to the criminal and civil law, that "a person intends the natural and foreseeable consequences of his voluntary actions").

On the facts of this case, there would then be no need to engage the issue of ascribing Hanover's fraudulent intent to Adler. Hence, the Trustee would be entitled to relief under § 548(a)(1)(A). *See Salmon I*, at 13-14. Had the bankruptcy court viewed the evidence of Adler's knowledge and complicity to be as clear and convincing as Appellants assert it is, the court could have concluded that Adler itself possessed the requisite intent to defraud its creditors. It then would not have found it necessary to reach that result obliquely, without clear and controlling authority, by extending the domination or control doctrine to the facts of this case.

Recognizing this conceptual quandary, and the contradiction in Appellants' position, the bankruptcy court nonetheless applied the imputed intent rule because it was persuaded that the record did [**235] not adequately support a finding of Adler's sufficient knowledge and involvement in Hanover's fraud. *See Decision*, 247 B.R. at 94. Accordingly, in accepting Appellants' argument here, the Court would be compelled to reverse the conclusion it reached above that the conditions for avoidance pursuant to § 548(a)(1)(A) are not satisfied in this case because the element of the debtor's intent to defraud could not be established by imputing Hanover's misconduct through the domination or control rule.

e. *Adler's Claimed Guarantee*

The Court also finds no basis for reversing the bankruptcy court's ruling rejecting Appellants' argument that the Trustee's claim for rescission of the Challenged Trades based on Hanover's fraud cannot prevail, and that the transactions are enforceable despite Hanover's fraud, on the ground that Adler had guaranteed all of Hanover's trades. In support of that assertion, Appellants relied upon the testimony of their expert and other witnesses, as well as on judicial admissions the Trustee purportedly made in allegations contained in the complaint that initiated this case and in related documents. *See* Appellants' [*492] Brief at 99-104. The bankruptcy [**236] court found that the evidence to which Appellants refer did not establish the existence of a guarantee by Adler of all of Hanover's proprietary trades. Rather, the Trustee acknowledged, and the court held, that such a guarantee existed only as to Hanover's trades with the Street. *See Decision*, 247 B.R. at 119-20.

Under New York law, a special promise to answer for the debt, default or financial obligations of another person must be in writing. *See* N.Y. Gen. Oblig. Law § 5-701 (McKinney 1989); *Martin Roofing, Inc. v. Goldstein*, 60 N.Y.2d 262, 457 N.E.2d 700, 469 N.Y.S.2d 595 (N.Y. 1983); *Griffin v. Bookman*, 39 N.Y.2d 57, 346 N.E.2d 534, 382 N.Y.S.2d 733 (N.Y. 1976). While Appellants strenuously argue at length to establish the existence of the supposed guarantee through the testimony of numerous witnesses, some of them unrelated to Adler, they cite no document written and executed in accordance with the requirements of the law that confirms the reality and terms of the claimed guarantee as it pertains to Hanover's proprietary trades of House Stocks. Insofar as Appellants sought to locate the guarantee in the Clearing Agreement, Customer Agreement and Alder's [**237] confirmations, the bankruptcy court found no evidence of such a guarantee there. *See Decision*, 247 B.R. at 119. Neither has this Court's review of those documents produced the supposed guarantee.

Appellants' expert at trial claimed that the source of the guarantee was paragraph 3(a) of the Clearing Agreement, though conceding that the provision makes no reference to the term "guarantee". *See id.* Moreover, the irrevocable guarantee Appellants invoke is contradicted by paragraph 3(b) of the Clearing Agreement, which expressly grants Adler the right to cancel any transaction introduced by Hanover "for any reason". Clearing Agreement, P 3(b). Moreover, paragraph 13 of the Clearing Agreement states that Adler "shall have no liability to any Introduced Accounts for any loss suffered by them." *Id.*, P 13(b).

Appellants' search for the putative guarantee in industry practice is equally unavailing. The bankruptcy court found unpersuasive Appellants' expert's trial testimony that it was "customary" for clearing firms to back the obligations of introducing firms to customers in the event the latter failed to pay on settlement. *See Decision*, 247 B.R. at 119. [**238] The court noted that the expert failed to specify the nature, terms or instances of the existence or enforcement of this "customary obligation". *See id.* On the other hand, the Trustee's expert testified to the contrary, stating that "he has spoken to the major clearing firms in this country and was explicitly advised that they 'do not guarantee [such] trades'." *Id.* The bankruptcy court concluded that this testimony was more persuasive and more consistent with the plain language of the Clearing Agreement. *See id.*

The issue of the existence of a guarantee and the scope of a guarantor's obligations pursuant to such a claimed agreement is a question of law determined by applicable principles of contract and suretyship law. *See Martin Roofing*, 457 N.E.2d at 701. The testimony of expert witnesses, or even parties, however clear or cogent, cannot give rise to an agreement not manifest in any writing, or that relevant documents expressly deny. This Court finds no basis for overturning the bankruptcy court's findings and conclusions on this issue.

F. *RESCISSION OF TRADES AS ILLEGAL CONTRACTS*

1. *Illegality Under Securities Laws*

The bankruptcy court, [**239] applying the common law doctrine concerning the unenforceability [*493] of illegal contracts, granted the Trustee's application to rescind the Challenged Trades on the grounds that the transactions violated the criminal provisions of three securities statutes: § 10(b) of the Securities Exchange Act of 1934 (the "SEC Act"), 15 U.S.C. § 78(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5; the illegality provisions of SIPA, 15 U.S.C. § 78jjj(c); and New York's Martin Act, N.Y. Gen. Bus. L. § 352(1) (McKinney 1996) (the "Martin Act"). Each of these statutes declares unlawful the use of any device, scheme or artifice to defraud any person in connection with securities transactions subject to the statues. *See id.* [56]

[**240] Appellants do not dispute that in booking the Challenged Trades their Hanover brokers engaged in criminal conduct that contravened these statutes. Rather, they contend that Appellants personally did not violate any law and that the illegality of contract principle is an extraordinary equitable remedy not available to the Trustee to invoke against Appellants. *See* Appellants' Brief at 104. In particular, Appellants take issue with the bankruptcy court's application of § 29(b) of the SEC Act, [57] which Appellants contend permits rescission of illegal contracts only against direct violators with actual knowledge, and not against innocent parties.

[**241] Appellants raise no specific issue as to the application of the criminal provisions of SIPA or the Martin Act. Instead they argue that, assuming their relevance, public policy and equitable considerations weigh in favor of enabling Appellants to enforce the Challenged Trades. *See id.* at 107. In essence, they maintain that the Trustee possesses other remedies he has already pursued against Hanover and the Illegal Short Sellers to vindicate the wrongs committed here, and therefore no equitable policy or statutory purpose would be served by permitting the Trustee to apply the illegality principle against innocent customers. This Court finds no merit in Appellants' arguments. Nor does it see sufficient legal basis to disturb the bankruptcy court's reasoning and conclusions relating to this issue.

Under both federal and New York law, illegal contracts are unenforceable. *See Kaiser Steel Corp. v. Mullins*, 455 U.S. 72, 77-78, 70 L. Ed. 2d 833, 102 S. Ct. 851 (1982); *Benjamin v. Koeppel*, 85 N.Y.2d 549, 650 N.E.2d 829, 830, 626 N.Y.S.2d 982 (N.Y. 1995). The New York general rule is articulated in *Benjamin*:

> [*494]
>
> Illegal contracts are, as a general [**242] rule, unenforceable. However, the violation of a statute that is merely malum prohibitum will not necessarily render a contract illegal and unenforceable. If the statute does not provide expressly that its violation will deprive the parties of their right to sue on the contract, and the denial of relief is wholly out of proportion to the requirements of public policy . . . the right to recover will not be denied.

650 N.E.2d at 830 (internal quotation marks and citations omitted).

Appellants' reliance on general expressions of public policy and the purposes of the securities laws minimizes the severity of the extensive and deliberate fraud their brokers committed while acting within the scope of their agency. Appellants seek to enforce the benefits of their agents' wrongful acts, while ignoring the effects of those offenses on some of the central purposes of the securities laws. The misconduct here was no "merely malum prohibitum", but an uncontested, massive onslaught on the law, contravening three pertinent

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[56] In relevant part, SIPA's criminal penalty provision applies in particular to any person who, directly or indirectly, in connection with or in contemplation of any liquidation or direct payment procedure -

> (C) fraudulently or with intent to defeat this chapter -- (i) conceals or transfers any property belonging to the estate of the debtor . . . (iv) receives any material amount of property from a debtor . . .

15 U.S.C. § 78jjj(c).

[57] Under § 29(b) of the 1934 Act:

> Every contract made in violation of any provision of this Act or of any rule or regulation thereunder, and every contract . . . heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this Act or any rule or regulation thereunder, shall be void (1) as regards to the rights of any person, who in violation of such provision, rule or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards to the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule or regulation.

15 U.S.C. § 78cc(b).

federal and state securities statutes, that comprises conduct wrong in itself. *See Palazzetti Import/Export, Inc. v. Morson*, 1999 U.S. Dist. LEXIS 9350, No. 98 Civ.0722, 1999 WL [**243] 420 403, *2 (S.D.N.Y. June 23, 1999). The statutory framework of these laws encompasses criminal prohibitions intended to punish and discourage precisely the wrongs Hanover's brokers committed. Rewarding parties who seek to avail themselves of the fruits of their agents' fraud would serve to advance no stated public policy expressed or implied in these statutes or articulated by any tenet of common sense.

2. *Exceptions for Innocent Parties*

The securities laws undeniably and for sound reason do provide exceptions to protect the legitimate trades and expectations of truly innocent parties. In claiming the mantle of innocence, however, Appellants' argument is premised on a point the bankruptcy court rejected: that in executing the Challenged Trades Hanover did not act as Appellants' authorized agent, in that connection making the fraudulent misrepresentations which in part constituted Hanover's criminal violations of § 10(b), SIPA and the Martin Act. This Court, in sustaining the bankruptcy court's conclusion, rejected Appellants' premise as well. *See* discussion *supra* Part III.C.1.c.

Appellants' reliance on *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 128 L. Ed. 2d 119, 114 S. Ct. 1439 (1994), [**244] for the proposition that they cannot be held responsible for Hanover's SEC Act violations is misplaced. *Central Bank* dealt with whether Rule 10b-5 liability extended separately to parties who aid and abet violations of the securities laws based on their own conduct that did not manifest the requisite fraudulent intent to break the law. The case did not expressly deal with the scope of liability by principals for securities violations committed by their broker-agents through actions taken within the scope of their authority.

The latter question has arisen in several cases in this District and has engendered disagreement among the courts. Some have held that an agency theory of liability remains available in Rule 10b-5 cases after *Central Bank*. *See Vento & Co. of New York, LLC v. Metromedia Fiber Network, Inc.*, 1999 U.S. Dist. LEXIS 3020, *37, No. 97 Civ. 7751, 1999 WL 147732, *12 (S.D.N.Y. Mar. 18, 1999) ("If *Central Bank* had precluded the liability of a principal for the misconduct of its agent, that decision would have prevented any liability by corporations or partnerships under Rule 10b-5 since such legal entities can only act through their natural agents. [*495] There is no indication that [**245] the Supreme Court intended such a drastic restriction on the possible defendants in securities fraud lawsuits."); *In re Kidder Peabody Sec. Litig.*, 10 F. Supp. 2d 398, 407 (S.D.N.Y. 1998); *In re ICN/Viratek Sec. Litig.*, 1996 U.S. Dist. LEXIS 4407, No. 87 Civ. 4296, 1996 WL 164732, *6 (S.D.N.Y. Apr. 9, 1996); *Pollack v. Laidlaw Holdings, Inc.*, 1995 U.S. Dist. LEXIS 5909, No. 90 Civ. 5788, 1995 WL 261518, *17 (S.D.N.Y. May 3, 1995).

Other courts have determined that after *Central Bank*, Rule 10-5 claims based on agency liability are no longer sustainable. *See Converse, Inc. v. Norwood Venture Corp.*, 1997 U.S. Dist. LEXIS 19106, No. 96 Civ. 3745, 1997 WL 742534, *3 (S.D.N.Y. Dec. 1, 1997); *ESI Montgomery County, Inc. v. Montenay Int'l Corp.*, 1996 U.S. Dist. LEXIS 592, No. 94 Civ. 0119, 1996 WL 22979, *3 (S.D.N.Y. Jan. 23, 1996).

This Court finds that the better argument is made by the courts which have held that *Central Bank* does not bar application of agency principles to support liability in securities fraud cases. Judge Koeltl's reasoning in *Vento* is persuasive. *See Vento*, 1999 WL 147732, at *12. There the Court observed that in *Central Bank* the Supreme Court was concerned primarily [**246] with "broadening the range of unlawful conduct beyond that specifically prescribed by the [Exchange] Act." *Id.* (quoting *American Telephone and Telegraph Co. v. Winback and Conserve Program, Inc.*, 42 F.3d 1421, 1430 (3rd Cir. 1994)).

In *Winback*, the Third Circuit, noting that courts imposing liability on agency theories do not expand the scope of affirmative conduct proscribed by the relevant statute, held that *Central Bank's* discussion of aiding and abetting liability "should not be transplanted into the more settled realm of agency law." 42 F.3d at 1430-31. The court further added: "The principal is held liable not because it committed some wrongdoing outside the purview of the statute which assisted the wrongdoing prohibited by the statute, but because its status merits responsibility for the tortuous actions of its agents." *Id.; see also Seolas v. Bilzerian*, 951 F. Supp. 978, 983 (D. Utah 1997).

The same agency law principles vitiate Appellants' claim as "innocent parties" entitled to the protection accorded by SEC Act § 29(b) to non-violators without actual knowledge that the making or enforcement of the contract was [**247] in violation of the SEC Act. The plain language of that provision casts doubt on

Appellants' invocation of its safeguards. The contracts the Trustee in these proceedings seeks to rescind as illegal are the Challenged Trades Hanover executed on Appellants' behalf in accordance with the terms of the Clearing Agreement and the Customer Agreements. Appellants spent considerable energies arguing earlier in this appeal that they were parties to these very contracts, that their contracts became irrevocable on the trade date and that Appellants are entitled to enforce them. Hanover's knowledge of the illegal means it employed as Appellants' agent to execute the Challenged Trades may be imputed to Appellants. *See* discussion *supra* Part III.C.1.c.(ii).

The Court has considered Appellants' citation of *Occidental Life Ins. Co. of N.C. v. Pat Ryan & Assocs., Inc.*, 496 F.2d 1255, 1265-66 (4th Cir.), *cert. denied*, 419 U.S. 1023, 42 L. Ed. 2d 297, 95 S. Ct. 499 (1974) to support their assertion of rights under § 29(b). The Court considers the case, which deals with election of remedies, inapposite to the issues here on appeal. *See* 496 F.2d at 1265-66 [**248] (stating that § 29(b) is "more properly viewed as an adjunct to the other remedies provided by the [SEC Act] and . . . should be read as complementing those remedies available to the injured party and not as being antagonistic"). Rather, the case reinforce the common law rule the bankruptcy court properly [*496] applied here that illegal contracts are voidable at the electron of the victim. *See Kidder Peabody & Co. v. Unigestion Int'l Ltd.*, 903 F. Supp. 479, 498 (S.D.N.Y. 1995) ("contracts to purchase securities were induced through fraud in violation of the anti-fraud provisions of the Exchange Act, thus rendering those contracts 'unlawful contracts' under § 29.").

IV. ***CONCLUSION AND ORDER***

For the reasons set forth above, it is hereby

ORDERED that the Court's May 3, 2001 Order in this matter be amended as set forth herein; and it is further

ORDERED that the judgment of the bankruptcy court in this matter is affirmed, except insofar as the bankruptcy court purports to approve the Trustee's avoidance of the Challenged Trades pursuant to § 548(a)(1)(A) of the Bankruptcy Code and § 276 of the New York Debtor and Creditor Law; and it is finally

[**249] **ORDERED** that the Clerk of the Court close this case.

SO ORDERED.

Dated:

New York, New York

June 11, 2001

Victor Marrero

U.S.D.J.

End of Document

TAB 6

142 S.Ct. 1128
Supreme Court of the United States.

Timothy O. MARKLAND, Petitioner,
v.
ASSET ACCEPTANCE, LLC.

No. 21-982.

|
February 22, 2022

Opinion
Petition for writ of certiorari to the Court of Civil Appeals of Oklahoma, Fourth Division denied.

All Citations

142 S.Ct. 1128 (Mem), 212 L.Ed.2d 18

End of Document

TAB 7

2002 CarswellOnt 208
Ontario Superior Court of Justice

Mian v. Kalezic

2002 CarswellOnt 208, [2002] O.J. No. 264, [2002] O.T.C. 59, 111 A.C.W.S. (3d) 361

Abdul Qayyum Mian, Plaintiff and Mike Kalezic and 1009954 Ontario Inc. and Marta Kalezic and Kahlon Family Holdings Ltd., Defendants

Sachs J.

Heard: October 29 - December 5, 2001
Judgment: January 24, 2002
Docket: 95-CU-91512

Counsel: *Donald J. Brown, Q.C.*, for Plaintiff
Morris A. Singer, for Defendant, Kahlon Family Holdings Ltd.

Table of Authorities

Cases considered by *H. Sachs J.*:

Chippewas of Sarnia Band v. Canada (Attorney General), 2000 CarswellOnt 4836, 51 O.R. (3d) 641, 195 D.L.R. (4th) 135, 139 O.A.C. 201, 41 R.P.R. (3d) 1, [2001] 1 C.N.L.R. 56 (Ont. C.A.) — considered

Statutes considered:

Business Corporations Act, R.S.O 1990, c. B.16

s. 53(1) "security" — considered

s. 56(3) — considered

s. 69 — considered

s. 69(1) — considered

s. 69(2) — considered

Fraudulent Conveyances Act, R.S.O 1990, c. F.29

s. 2 — considered

s. 3 — considered

Registry Act, R.S.O 1990, c. R.20

s. 70 — considered

s. 70(1) — considered

s. 71 — considered

***H. Sachs J.*:**

Introduction

1 This case illustrates the dangers inherent in attempting to disguise the true nature of a commercial transaction, particularly when one of the parties to that transaction is unscrupulous. It arises from the purported transfer by the Defendant, Mike Kalezic, of the shares of the corporate defendant, 1009954 Ontario Inc. ("Numbered Company"), to Mohindor Kahlon. The purpose of

the share transfer was to facilitate the transfer of the sole asset of Numbered Company, a motel. However, in order to avoid the necessity of obtaining the approval of the existing first mortgagee to the transaction, the transaction was structured as the transfer of shares as opposed to a transfer of real estate. This transfer was clearly in violation of an agreement between Mr. Kalezic, Numbered Company and the Plaintiff, Abdul Quayyum Mian (the "Agreement"). Under the Agreement Mr. Kalezic was prohibited from transferring the shares of Numbered Company without Mr. Mian's consent.

2 The shares of Numbered Company were transferred to Mr. Kahlon by Mr. Kalezic without Mr. Mian's knowledge or consent. Similarly, there was no evidence that as of the date of this transfer Mr. Kahlon had any knowledge of the Agreement. As already indicated, the only asset of Numbered Company was a motel. Under the Agreement, Mr. Mian was entitled to fifty percent of the net proceeds realized from the sale of the motel. After learning of the Agreement from Mr. Mian, Mr. Kahlon, as the sole shareholder of Numbered Company, caused Numbered Company to transfer the motel to his family holdings company, Kahlon Family Holdings Ltd. ("Family Holdings"). The consideration for the transfer was the amount outstanding on the mortgages, approximately $200,000.00 less than the amount paid by Mr. Kahlon for the shares of Numbered Company some six months earlier.

3 In this lawsuit the Plaintiff, Mr. Mian, has challenged the validity of the transfer of the motel to Family Holdings and is seeking damages. In its defence, Family Holdings has asserted that Mr. Kahlon acquired the motel as a good faith purchaser for value without notice and that the subsequent transfer to them cannot be attacked.

4 The Defendants, Mike and Marta Kalezic, did not appear at the trial of the action and no claims for relief were sought against them. Mike Kalezic is now a bankrupt and both counsel who did appear agreed that there was reason to believe that Marta Kalezic was a pseudonym used by Mike Kalezic.

Facts

5 The facts in this case were not the subject of much dispute. Most of the evidence consisted of various documents. The only witness who testified was the Plaintiff, Mr. Mian. Mohinder Kahlon died before the trial and thus, on consent, the transcript of his examination for discovery was filed as part of the defendant's case.

6 On December 7, 1992, Mr. Kalezic became the sole shareholder of Numbered Company. On December 21, 1992 Numbered Company purchased the motel that was located at 3300 Kingston Road, Toronto for $525,000.00. As part of the consideration for that purchase Numbered Company gave a mortgage back to Sunlife Trust Company for the amount of $470,000.00. Mr. Kalezic guaranteed that mortgage.

7 On March 1, 1993, Mr. Mian purchased Mr. Kalezic's shares in Numbered Company. This transfer was partly paid for through the granting of a $110,000.00 mortgage to Marta Kalezic on the motel. At the time of this transfer the motel was boarded up. Mr. Mian invested considerable funds to make it operational again. He then leased it to his brother and his brother's partner to operate. In exchange he was paid a monthly rental fee of $10,000.00. From this money he paid all of the expenses in relation to the motel, including the Sunlife and Kalezic mortgages.

8 In the fall of 1994, Mr. Mian's brother had a dispute with a police officer. As a result, according to Mr. Mian, the officer had Mr. Mian, his brother and his brother's partner charged with defrauding a number of the motel's clients, most of whom were in receipt of government assistance of some kind. According to Mr. Mian the charges were laid as an act of revenge and never had any basis in reality. As a condition of their bail, all three were prohibited from going near the motel. Thus, Mr. Mian found himself with no one to operate the motel.

9 In the meantime, Mr. Mian and Mr. Kalezic had become friends. Therefore, Mr. Mian approached Mr. Kalezic, who was a real estate agent, and asked him if he knew of anyone who could operate the motel until his criminal charges were resolved. Mr. Kalezic expressed interest in running the motel himself. As a result, on October 12, 1994 Mr. Mian and Mr. Kalezic entered into a written agreement (the "Agreement"). Numbered Company was also a party to the Agreement. The significant provisions of the Agreement were as follows:

(i) Mr. Kalezic agreed to pay Mr. Mian $20,000.00 as consideration for the transfer to him of all the issued shares in Numbered Company "and its property at 3300 Kingston Road, Scarborough, Ontario."

(ii) Mr. Kalezic undertook to run the motel.

(iii) Mr. Kalezic agreed that the motel was to be sold at fair market value as soon as practicable and that "any excess amount realized after paying off the existing first and second mortgages...shall be divided 50% each to Mike Kalezic/Corporation and 50% of the net realization shall be paid to Abdul Qayyum Mian."

(iv) The Agreement was to be recorded in the Minute Book of Numbered Company.

(v) Mr. Kalezic agreed to consult with Mr. Mian regarding the sale of the motel.

(vi) Mr. Kalezic became the sole director of Numbered Company and agreed not to transfer or issue any shares in Numbered Company without the express written consent of Mr. Mian.

(vii) Both Mr. Kalezic and Numbered Company undertook "to abide by all the terms of this agreement and jointly and severally bound themselves to observe the covenants".

10 Mr. Mian testified that his purpose in entering into the Agreement was twofold:

(a) To have someone to operate the motel for him while he was being prosecuted; and

(b) To remove his name from any ownership in the motel so that the police would not think that he was still involved in the motel's operation.

11 According to Mr. Mian, the Agreement was inserted in Numbered Company's minute book. However, at Mr. Kalezic's insistence, the minute book was released to Mr. Kalezic once the share transfer to him was effected. The share certificate evidencing the transfer to Mr. Kalezic made no reference to the Agreement.

12 On December 20, 1994, Mr. Kahlon entered into an Agreement of Purchase and Sale with Numbered Company to purchase the motel for $812,000.00. In this agreement Mr. Kahlon agreed to assume the existing first mortgage to Sunlife and to replace the second mortgage to Marta Kalezic with a new one in the amount of $205,000.00. Numbered Company promised to discharge the existing second mortgage to Marta Kalezic. Mr. Kahlon agreed to assume certain specified work orders and "to take over all existing share of 1009954 Ontario Inc. on closing." *(sic)*

13 The transaction contemplated by the above agreement closed on January 12, 1995. However the documentation evidencing the transaction did not involve a transfer of the motel from Numbered Company to Mr. Kahlon. Instead the following documents were executed:

(i) A trust agreement between Mr. Kalezic, Mr. Kahlon and Numbered Company. Pursuant to this agreement Mr. Kalezic became the "bare trustee" of the shares of Numbered Company. He agreed to hold these shares in trust for Mr. Kahlon, who was now the agreed beneficial owner of the shares. Mr. Kalezic agreed to grant Mr. Kahlon a power of attorney over the shares and to transfer the shares to Mr. Kahlon upon his written request. The purpose of the arrangement is set out in paragraph 8 of the trust agreement as being "to facilitate the sale of the property known municipally as 3300 Kingston Road, Scarborough, Ontario...and as the within agreement elevates (*sic*) the necessity of the purchaser, Mohinder Singh Kahlon of applying to be approved to assume the aforesaid first mortgage." During the trial before me it was confirmed that the goal of these arrangements was to avoid the need to obtain the approval of the first mortgagee, Sunlife, to the transfer of the property. By virtue of these arrangements the property itself was never transferred. It remained in the name of Numbered Company.

(ii) A power of attorney from Mr. Kalezic to Mr. Kahlon. That power of attorney was subject to the following restriction: "This Power of Attorney is limited strictly to the fifty-one (51) common shares held by Mike Kalezic in the corporation known as 1009954 Ontario Inc. Therefore, it is acknowledged and agreed that the within Power of Attorney is absolutely irrevocable and is limited to strictly the endorsement and transfer of the fifty-one (51) common shares currently held by the aforesaid Mike Kalezic in 1009954 Ontario Inc."

(iii) A statutory declaration signed by Mr. Kalezic in which he swore that he had full authority to transfer the shares of Numbered Company, that he had done nothing to encumber the shares and that he was not aware of any existing claims or liens against the shares. Mr. Kalezic also signed another statutory declaration in which he swore that there were no claims that could be made against the assets of Numbered Company.

(iv) A power of attorney from Marta Kalezic to Mike Kalezic pursuant to which Mr. Kalezic executed the discharge of the existing second mortage.

(v) A new second mortgage in the amount of $205,000.00 to Marta Kalezic that was signed by Mr. Kahlon on behalf of Numbered Company.

14 Some months after the above transaction was completed all criminal charges against Mr. Mian, his brother and his brother's partner were withdrawn. Mr. Mian also received information that someone other than Mr. Kalezic was now running the motel. As a result of this information he contacted Mr. Kahlon and arranged to meet with him. He met with him in July of 1995 and at that meeting he made him aware of, and gave him a copy of the Agreement. Mr. Kahlon's response was that he had known nothing about the Agreement and that Mr. Mian should pursue his claims as against Mr. Kalezic. Mr. Mian did contact Mr. Kalezic, who admitted to the transfer, and attempted to settle matters with Mr. Mian. These negotiations were unsuccessful.

15 On August 9, 1995, Mr. Kahlon executed a transfer of the motel on behalf of Numbered Company to Family Holdings. The Land Transfer Tax Affidavit, which was signed by Mr. Kahlon as the President of Family Holdings, stated that the total consideration for the transaction was $600,000.00, the value of the mortgages being assumed.

16 On September 29, 1995, Mr. Mian commenced this action as against the Kalezics and Numbered Company. He also filed a Certificate of Pending Litigation against the motel.

17 In November of 1995, Mr. Kahlon's solicitor wrote to Mr. Kalezic's solicitor complaining about the fact that there were a number of work orders outstanding on the motel that had not been discharged and that were not listed on the original agreement of purchase and sale between Mr. Kahlon and Numbered Company, but were in existence at the time of that agreement. In March of 1997, Family Holdings brought a motion to discharge the Certificate of Pending Litigation that had been registered against the motel by Mr. Mian. That motion was dismissed in June of 1997. On July 4, 1997, Mr. Mian brought a motion to add Family Holdings as a defendant to this action. On July 9, 1997, the $205,000.00 mortgage to Marta Kalezic was discharged in exchange for a release with respect to the undisclosed work orders that were the subject of the correspondence in November of 1995 from Mr. Kahlon's lawyer to Mr. Kalezic's lawyer. In December of 1997, Family Holdings was added a party to this proceeding.

The Position of the Parties

18 The Plaintiff, Mr. Mian, submits that he is entitled to attack the conveyance of the motel to Family Holdings because at the time of that transfer Family Holdings clearly had notice of the Agreement and had transferred the motel in order to defeat Mr. Mian's claim under the Agreement.

19 The Defendant, Family Holdings, hold themselves out as good faith purchasers for value without notice. They assert that whether Mr. Kahlon acquired land or shares in the transaction that occurred on January 12, 1995, he is protected from claims made by the Plaintiff because he had no notice at that time of the Agreement. Further, they argue that the sale of the motel that took place in August of 1995 from Numbered Company to Family Holdings is protected because, as a good faith purchaser for value without notice, what Mr. Kahlon did with his assets is beyond the reach of the Plaintiff. They further submit, based

on a principle of equity, that, if Mr. Kalezic's fraud caused the loss between two innocent parties (Mr. Kahlon and Mr. Mian), the loss should be borne by Mr. Mian, because it was Mr. Mian who deliberately entered into an arrangement that he wished to keep hidden from the police.

The Statutory Framework

Ontario Business Corporations Act [1]

20 Section 69 of the *Ontario Business Corporations Act (OBCA)* states:

> (1) Upon delivery of a security, the purchaser acquires the rights in the security that the transferor had or had actual authority to convey except that a purchaser who has been a party to any fraud or illegality affecting the security or who as a prior holder had notice of an adverse claim cannot improve the purchaser's position by taking from a later good faith purchaser.
>
> (2) A good faith purchaser in addition to acquiring the rights of a purchaser also acquires the security free of any adverse claim.

21 "Security" is defined in section 53:

> "security" means a share, participation or other interest in property, rights or an enterprise of an issuer, or an obligation of an issuer, or any right to acquire such a share, participation, interest or obligation, of a type commonly dealt in upon securities exchanges or markets or commonly recognized as a medium for investment in any area in which it is issued or dealt in.

22 Section 56 (3) of the *OBCA* states:

> Where a share certificate issued by a corporation or by a body corporate before the body corporate was continued under section 180 is, or becomes, subject to,
>
> (a) a restriction on its transfer other than a restiction refered to in subsection (8);
>
> (b) a lien in favour of the corporation;
>
> (c) a unanimous shareholder agreement; or
>
> (d) an endorsement under subsection 185 (13),
>
> the restriction, lien, agreement or endorsement is ineffective against a transferee of the share who has no actual knowledge of it, unless it or a reference to it is noted conspicuously on the share certificate.

The Registry Act [2]

23 *The Registry Act* provides:

> 70 (1) After the grant from the Crown of land, and letters patent issued therefor, every instrument affecting the land or any part thereof shall be adjudged fraudulent and void against any subsequent purchaser or mortgagee for valuable consideration without actual notice, unless the instrument is registered before the registration of the instrument under which the subsequent purchaser or mortgagee claims.
>
> 71. Priority of registration prevails unless before the prior registration there has been actual notice of the prior instrument by the person claiming under the prior registration.

Analysis

January 12, 1995 Transaction

24 The parties do not agree on how the transaction that occurred on January 12, 1995 should be characterized or what liabilities flow from the respective characterizations. Was the transaction a share purchase, an asset purchase or both?

Share purchase

25 The Defendant argues that if the transaction was a share purchase, they are protected as the subsequent purchaser from a good faith purchaser for value without notice. Section 56(3) of the *OBCA* states that unless a purchaser of shares has actual knowledge of a restriction, or that restriction is "noted conspicuously" on the actual certificate, the restriction is ineffective. Therefore, because Mr. Kahlon had no actual notice of the Agreement and no mention of the Agreement was noted on the share certificate, he is protected from the Plaintiff's claims.

26 Section 69 of the *OBCA* echoes this principle. Shares are included in the definition of "security" and section 69 states that a good faith purchaser of a security acquires not only the rights of the transferor to the security, but also acquires the security free from any adverse claims. Since Mr. Kahlon had no knowledge of the Agreement, if the transaction was a share transfer, Mr. Kahlon acquired those shares free from the claims Mr. Mian could advance against those shares.

27 However, if the January 12, 1995 transaction was just a share purchase this raises the question of whether, given that Numbered Company was a party to the Agreement, it continued to be bound by the terms of that Agreement after the share transfer was effected. If it did, can the validity of the August 1995 transaction be challenged and that transaction set aside as a fraudulent conveyance?

28 Because corporations are set up with the express purpose of protecting shareholders from liability, a corporation must be held liable for its obligations under contract law. In his text, *The Law and Practice of Canadian Business Corporations* [3] Kevin Patrick McGuiness states:

> ...a corporation is said to have perpetual succession, which means that despite changes in the ownership of the corporation itself, the corporation continues to own its property and conduct its business without the need for successive conveyances and assignments of that property and business from one owner to the next. In this respect, perpetual existence resembles separation of ownership. Again, this feature of corporate existence is a logical consequence of separate personality. Despite the sale of the corporation it remains in existence unaffected as an artificial person. It continues as titleholder and owner of the property and business, even though there may be frequent and indeed continuous changes in its membership. The members of the corporation succeed to the property of the corporation. Changes in membership are merely a matter between the corporation and its members. They have no necessary implication with respect to the corporation and its property or with respect to dealings between the corporation and outsiders (emphasis added). [4]

29 McGuiness suggests that this separation is equally important when, as in this case, there is only one shareholder. "[The corporation] will be treated as an independent person with rights and liabilities belonging to itself even when there is a single owner of the corporation." [5]

30 Because Numbered Company was a separate legal entity, it had a legal obligation to abide by the contract it was a party to on October 12, 1994 (the Agreement). That obligation was separate from the obligations assumed by its shareholder, Mr. Kalezic, on his own behalf. This being the case, when Mr. Kahlon acquired his rights to the shares of Numbered Company, he did so subject to the obligations of Numbered Company, among which were its obligations under the Agreement. The question then becomes whether, in addition to being a share transfer, the January 12, 1995 transaction could also be considered a real estate transfer. If not, the next issue is whether the August 1995 transaction should be set aside as a fraudulent conveyance.

Was the January 12, 1995 transaction also an asset transfer?

31 The Defendant argues that the agreement of purchase and sale entered into between the parties relating to the January 12, 1995 transaction makes it clear that the real intention of the parties to that agreement was to convey the motel to Mr. Kahlon. It is their submission that if I look to what they argue is the real nature of the transaction in question, it will be clear that it was to transfer Numbered Company's sole asset, the motel.

32 If the transaction was an asset transfer then the Defendant is protected both by the equitable doctrine of the good faith purchaser for value (as discussed by the Ontario Court of Appeal in *Chippewas of Sarnia Band v. Canada (Attorney General)* at 734.[6]) and section 70 of the *Registry Act*. Because the evidence is that Mr. Kahlon had no actual notice of the Agreement at the time of the purchase and because the Agreement was not registered on the title to the motel, if, by virtue of the January 12, 1995 transaction, Numbered Company conveyed its interest in the motel to Mr. Kahlon, Mr. Kahlon was protected from any claims by the Plaintiff. He was free to sell the interest he had acquired in the motel at any time to any person even if that sale was effected after he had actual notice of the Agreement.

33 I agree that the intention of the parties as evidenced by the agreement of purchase and sale leading up to the January 12, 1995 transaction was to convey the motel to Mr. Kahlon from Numbered Company. However, in order to avoid the necessity of having to obtain the approval of the first mortgagee to the transaction, the parties decided to structure the transaction as a share purchase, with the legal title to the shares remaining in the hands of Mr. Kalezic. As a result no documentation was executed whereby the motel itself was transferred from Numbered Company to Mr. Kahlon. The parties were careful to ensure that legally the title to the motel was not transferred from its existing owner, Numbered Company. Having done so, can they now argue that in fact the transaction was one whereby title to the motel was conveyed, particularly where in making their argument they are relying partially on an equitable doctrine? I have concluded that they cannot. To find otherwise would be to allow a party to a commercial transaction to take one position as to the legal implications of that transaction when it is to their advantage to do so and to take another position when it is not. Such an approach not only encourages bad faith dealings, but would be inconsistent with one of the implicit purposes behind such sections as section 70 of the *Registry Act* and sections 56(3) and 69 of the *OBCA*; to promote the marketability of certain assets by increasing the extent to which third parties who deal with those assets may rely on the legal documentation evidencing ownership in those assets.

34 I appreciate that the effect of this conclusion may be to make the Defendant bear the consequences of the actions of an unscrupulous third party when, at the time of their dealings with this third party they had no idea of the Plaintiff's claims. However, I also find that this was the risk inherent in the way they, for their own reasons, chose to structure the transaction. If they had wished the main asset of Numbered Company to be protected from the undisclosed obligations of Numbered Company they could have sought the approval of the first mortgagee, conveyed the motel to Mr. Kahlon as originally contemplated and paid the Land Transfer Tax that would have been due on the closing of that transaction. It was they who chose to do otherwise and having done so must live with the legal consequences that flow from that decision.

Should the August 9, 1995 transaction be set aside as a fraudulent conveyance?

35 Section 2 of the *Fraudulent Conveyances Act*[7] states:

> Every conveyance of real property or personal property and every bond, suit, judgment and execution heretofore or hereafter made with intent to defeat, hinder, delay or defraud creditors or others of their just and lawful actions, suits, debts, accounts, damages, penalties or forfeitures are void as against such persons and their assigns.

36 Therefore, if I find that the conveyance of the motel from Numbered Company to Family Holdings was intended to defeat Mr. Mian's claims under the Agreement, the transaction of August 9, 1995 is void as against Mr. Mian and the motel will once again become the property of Numbered Company.

37 Section 3 of the *Fraudulent Conveyances Act* states:

Section 2 does not apply to an estate or interest in real property or personal property conveyed upon good consideration and in good faith to a person not having at the time of the conveyance to the person notice or knowledge of the intent set forth in that section.

38 This section affords no defence to Family Holdings as Mr. Kahlon was the President of Family Holdings. As such, Family Holdings would have had the same knowledge and intent as Mr. Kahlon. At the time of the August 9, 1995 transaction Mr. Kahlon clearly had knowledge of the Plaintiff's claims under the Agreement. The only question is whether Mr. Kahlon made the conveyance with the intention of defeating those claims. If he did, then section 2 applies and section 3 is of no assistance to Family Holdings as they would have known of that intent.

39 The burden to prove intent rests on the plaintiff. However, the plaintiff "may raise an inference of fraud sufficient to shift the evidentiary burden to the defendant if the plaintiff can establish that the transaction has characteristics which are typically associated with fraudulent intent." [8] The August 1995 transaction has a number of what have been referred to as the "badges of fraud", namely:

(i) Mr. Kahlon transferred the motel from one company controlled by him to another company controlled by him. As such, he effectively "continued in possession" of the property.

(ii) The consideration for the transaction was grossly inadequate, being over $200,000.00 less than the amount paid for the same property approximately six months earlier.

(iii) The transfer was made very shortly after Mr. Kahlon was advised of Mr. Mian's claims.

(iv) The transfer left Numbered Company, the debtor, without assets to satisfy any claims Mr. Mian might bring against it under the Agreement. [9]

40 No alternate explanation was advanced by the Defendant for the August 1995 transaction. Taking into account all of these circumstances, I am satisfied that the August 1995 transaction was one that was made with the intention to defeat Mr. Mian's claims under the Agreement. In view of this finding the transaction must be set aside as against Mr. Mian.

Relief

41 Under the Agreement Mr. Mian is entitled to 50% of the net proceeds realized from the sale of the motel. He is also entitled to require that Numbered Company proceed to sell the motel at fair market value. However, both counsel seemed to accept that if I found that Mr. Mian did have a remedy as against the Defendant, Family Holdings, that remedy should take the form of an award of damages in an amount equal to 50% of what Mr. Kalezic received in January of 1995. At that time he was paid $90,000.00 by way of cash and $95,000.00 by way of an increased mortgage back. Mr. Mian's share of these amounts is $92,500.00. I would ask that counsel confirm that they are prepared to agree that, given the findings I have made with respect to the validity of the August 1995 transaction, I should grant judgment against the Defendants in the amount of $92,500.00. If they are not, I may be addressed further with respect to the question of the appropriate relief. If judgment is granted in this form I also propose to award the Plaintiff prejudgment interest on this amount from January 12, 1995. I would ask counsel to make submissions to me with respect to the appropriate rate of such interest. Submissions with respect to the issues raised by me in this paragraph may be made in writing within two weeks from the date of the release of these reasons.

Action allowed.

Footnotes

1 R.S.O. 1990, c. B.16.

2 R.S.O. 1990, c. R.20.

3 K. P. McGuiness, *The Law and Practice of Canadian Business Corporations*, (Toronto: Carswell, 1999).

4 *Ibid.* page 65.

5 *Ibid.* page 17.

6 51 O.R. (3d) 641 (Ont. C.A.) at 734.

7 R.S.O. 1990, c. F.29.

8 C.R.B. Dunlop, *Creditor-Debtor Law in Canada* (Toronto: Carswell, 1995) at page 613.

9 For a discussion of the recognized "badges of fraud" see Dunlop, ibid at pages 613-15.

TAB 8

1988 CarswellOnt 184
Ontario Supreme Court

Nuove Ceramiche Ricchetti S.p.A. v. Mastrogiovanni

1988 CarswellOnt 184, [1988] O.J. No. 2569, 76 C.B.R. (N.S.) 310

NUOVE CERAMICHE RICCHETTI S.p.A. v. MASTROGIOVANNI and CLASSIC TILE DISTRIBUTORS LTD.

Trainor J.

Judgment: November 23, 1988
Docket: Toronto No. 23013/84

Counsel: *E. Van Woudenberg* , for plaintiff.
B. Brucker , for defendants.

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Dougmoor Realty Hldg. Ltd., Re; Fisher v. Wilgorn Invt. Ltd., [1967] 1 O.R. 66, 10 C.B.R. (N.S.) 141, 59 D.L.R. (2d) 432 [reversed on other grounds [1968] 1 O.R. 61, 11 C.B.R. (N.S.) 153, 65 D.L.R. (2d) 419 (C.A.)] — *referred to*
Fancy, Re (1984), 46 O.R. (2d) 153, 51 C.B.R. (N.S.) 29, 8 D.L.R. (4th) 418 (S.C.) — *applied*
Lehndorff Can. Pension Properties Ltd. v. Davis & Co. (1987), 10 B.C.L.R. (2d) 342, 39 C.C.L.T. 196 (S.C.) — *referred to*
T.L. Raymond Elec. (London) Ltd. v. Idylwild Horne Ltd. (1984), 7 C.L.R. 210 (Ont. H.C.) — *referred to*

Statutes considered:

Bulk Sales Act, R.S.O. 1980, c. 52

Fraudulent Conveyances Act, R.S.O. 1980, c. 176

ss. 2-4

Words and phrases considered:

BADGES OF FRAUD

The "badges of fraud" referred to by Mr. Justice Anderson [in *Fancy, Re* (1984), 46 O.R. (2d) 153 (S.C.)] are those set out in *Re [Dougmor] Realty Hldg. Ltd.; Fisher v. Wilgorn Invt. Ltd.*, [1967] 1 O.R. 66 . . . (Ont. H.C.):

(1) secrecy

(2) generality of conveyance

(3) continuance in possession by debtor

(4) some benefit retained under the settlement to the settlor.

***Trainor J.* (orally):**

1 This action is for a declaration that the transfer of the assets of Classic Ceramic Tiles Importing and Distributing Ltd. ("Ceramic"), a company owned and controlled by Nicola Mastrogiovanni, in April 1983 to another company owned and

controlled by him, the defendant Classic Tile Distributors Ltd. ("Tile") is null and void as against the plaintiff because it was a fraudulent conveyance.

2 In addition, the plaintiff claims damages for conspiracy, fraud and punitive damages.

3 The plaintiff is an Italian company. It sold tiles to Ceramic and on 27th October 1983 obtained a consent judgment for $100,000 plus interest and costs against that company. The claim made by the plaintiff against Ceramic was defended up to the date of the consent judgment on 27th October 1983. The basis of the defence was that the tiles were defective.

4 Between the time of the transfer of assets on 4th April 1983 and the judgment in October 1983, the fact of the transfer was not disclosed by Ceramic or its principal, Mastrogiovanni, at the pre-trial that was held in the action, nor was it disclosed when the consent judgment was negotiated.

5 The principal of Ceramic failed to attend on examination as a judgment debtor. When a subsequent appointment was taken out he did attend but was not prepared to answer crucial questions. Rather than answer, he referred those questions to his accountant, who was not in attendance at the time. Subsequently, on 4th June, the accountant was examined in aid of execution and details of the transfer of assets were obtained.

6 Prior to the judgment Tile was incorporated and, as disclosed in the evidence, all of the assets of Ceramic were transferred to Tile. The defendant Mastrogiovanni says that the transfer of assets was not made to defeat the plaintiff's claim but was effected because Ceramic's reputation in Italy, with other tile suppliers, was ruined as a result of the dispute with respect to the defective tiles.

7 The defendant Mastrogiovanni testified that he was unaware of defects until he received customer complaints. He says he had to make good on the complaints by paying damages. He further testified that he sold all of the tiles but they had to be sold at reduced prices because of the complaints. He said that he sold the remaining tiles to cover his shipping and customs duty costs that had been prepaid.

8 The defence did not produce any invoices, documents or witnesses to support this evidence. On the other hand, in cross-examination, Mr. Mastrogiovanni agrees that to date the plaintiff has not been paid any money on account, either of the original indebtedness or on the judgment that was issued.

9 At the time of the transfer Ceramic owed the Royal Bank approximately $140,000 and that debt was secured by a number of securities. In addition, cash and personal assets of Mr. Mastrogiovanni and his wife were pledged with the bank. The total security held by the bank was far in excess of the debt. In basic terms, what transpired was that Mr. Mastrogiovanni, the controlling mind of Ceramic, without assistance of a solicitor, simply took the book value of Ceramic's chattels and inventory from that company's financial statements and at that value transferred those assets to Tile. Tile had been recently incorporated for the purpose of receiving the transfer. Tile, in turn, assumed the then bank debts.

10 Within a period of a few months the cash security held by the bank was dramatically increased, virtually doubled. Mr. Mastrogiovanni, without any supporting documents or witnesses, says this was accomplished because an aunt gave his wife a substantial sum of money that was pledged with the bank and, in addition, he received money from the sale of real estate he owned. He testified the bank received the mortgage payments from the real estate that he sold.

11 In the period from March 1983, the bank's security was augmented by the following cash securities: a $25,000 term deposit in March 1983, a $35,000 term deposit in May 1983, a further term deposit of $25,000 on 16th December 1983, a savings account pledge of some $22,000, assignment of the balance of a mortgage of $122,304, and lastly, a collateral mortgage on Mr. Mastrogiovanni's home of $60,000.

12 Shortly after the purported sale of assets, the new company moved to larger quarters a short distance away. Tile's first financial statement, dated February 1984, shows a bank debt of $300,000 and a substantial increase in the amount of inventory, over the inventory that had been held by Ceramic. The sale of assets by Ceramic had the effect of eliminating all of Ceramic's

trade accounts payable. They totalled approximately $155,000 as of the date of the sale, and 90 per cent of this liability was the plaintiff's trade account.

13 The transfer allowed Mr. Mastrogiovanni, in effect, to carry on the same business as he had previously carried on at a new and improved location and without the burden of the accounts payable of Ceramic. The sale was made without invoking the mandatory provisions of the Bulk Sales Act.

14 A cursory examination of the financial statements and the bill of sale discloses that Ceramic's accounts receivable, during the years 1980 through 1983, ranged between a low of $30,000 and a high of approximately $81,000 as of 31st March 1983 year end. At the time of the sale to Tile there were no receivables. The bill of sale does not show accounts receivable as an asset being transferred from Ceramic to Tile, nor does it show any value for goodwill.

15 Ceramic was, at the time, an operating company. There is no evidence of pressure from the bank or any other creditor except the plaintiff. Mr. Mastrogiovanni and his accountant did not deal with the matters that I have just referred to in their evidence. The financial statements contain no explanation, as they should, of the unusual transactions, particularly with respect to the disappearance of accounts receivable.

16 Mr. Brucker, counsel for the defendant, on these facts, wisely conceded that the circumstances were suspicious and that he had an obligation to call evidence. His position is that I should believe Mr. Mastrogiovanni in that he did not intend to defeat, hinder or delay the plaintiff, but he merely wished to start afresh and be able to deal with suppliers in Italy where Ceramic's name had lost its good reputation.

17 The law on the subject of fraudulent conveyances is accurately stated by Mr. Justice Anderson in *Re Fancy* (1984), 46 O.R. (2d) 153, 51 C.B.R. (N.S.) 29, 8 D.L.R. (4th) 418 (S.C.) . The relevant sections of this legislation are as follows:

> 2. Every conveyance of real property or personal property and every bond, suit, judgment and execution heretofore or hereafter made with intent to defeat, hinder, delay or defraud creditors or others of their just and lawful actions, suits, debts, accounts, damages, penalties or forfeitures are void as against such persons and their assigns.
>
> 3. Section 2 does not apply to an estate or interest in real property or personal property conveyed upon good consideration and *bona fide* to a person not having at the time of the conveyance to him notice or knowledge of the intent set forth in that section.
>
> 4. Section 2 applies to every conveyance executed with the intent set forth in that section notwithstanding that it was executed upon a valuable consideration and with the intention, as between the parties to it, of actually transferring to and for the benefit of the transferee the interest expressed to be thereby transferred, unless it is protected under section 3 by reason of *bona fides* and want of notice or knowledge on the part of the purchaser.

18 In *Re Fancy* , supra, Anderson J. said [p. 36]:

> The plaintiff must prove that the conveyance was made with the intent defined in that section. Whether the intent exists is a question of fact to be determined from all of the circumstances as they existed at the time of the conveyance. Although the primary burden of proving his case on a reasonable balance of probabilities remains with the plaintiff, the existence of one or more of the traditional "badges of fraud" may give rise to an inference of intent to defraud in the absence of an explanation from the defendant. In such circumstances there is an onus on the defendant to adduce evidence showing an absence of fraudulent intent. Where the impugned transaction was, as here, between close relatives under suspicious circumstances, it is prudent for the court to require that the debtor's evidence on *bona fides* be corroborated by reliable independent evidence.

19 The "badges of fraud" referred to by Mr. Justice Anderson are those set out in *Re Dougmoor Realty Hldg. Ltd.; Fisher v. Wilgorn Invt. Ltd.*, [1967] 1 O.R. 66, 10 C.B.R. (N.S.) 141, 59 D.L.R. (2d) 432 :

20 (1) secrecy

21 (2) generality of conveyance

22 (3) continuance in possession by debtor

23 (4) some benefit retained under the settlement to the settlor.

24 In this case, the badges that I have referred to specifically are present as well as others. The alter ego of both Ceramic and Tile, Mr. Mastrogiovanni, knew that the plaintiff's claim was proceeding to trial and yet he kept the transfer a secret even while consenting to judgment. The bill of sale was prepared without the aid of solicitors. It did not comply with the Bulk Sales Act and it, together with Ceramic's financial statements, fail to explain or account for the disappearance of the accounts receivable. There was no explanation given as to why a going concern was selling its assets at book value and without any amount disclosed for the value of goodwill.

25 Control of the assets following the transfer remained with Mr. Mastrogiovanni. He was able to carry on the same business on the same street under almost the same name. Even he confused the names during his testimony. As a consequence, not a day's work was lost nor a day's income and he was able to do this without the burden of the accounts payable that Ceramic had incurred. His explanation, unsupported by evidence that should have been readily available, if his explanation was true, bears little resemblance to reality.

26 The fact that he was able to raise substantial amounts of cash after the transaction had closed leads me to the irresistible inference that the money came from the collection of his receivables.

27 The use of the same street address by a company with virtually the identical name owned and operated by the same principal and carrying on the same business can hardly be said to accomplish the purpose of starting afresh and clearing one's name with its creditors. It is more consistent with keeping the goodwill of the old customers who did business with the previous company.

28 The defence argues that because the bank held security for its debt, the plaintiff has lost nothing. In my view, that contention is not supportable.

29 Firstly, receivables and goodwill should have been declared and they were not. Those assets would have been available to the plaintiff.

30 Secondly, the value of inventory is unrealistic for a going concern.

31 Thirdly, the bank manager of the Royal Bank, who held the security, was not called as a witness. I infer his evidence would not support the defence position. Bank security may or may not rank in priority to a trade creditor. There is nothing in the record to tell me that had the plaintiff seized inventory prior to the bank's securities crystallizing, the plaintiff would not have realized on its seizure.

32 The secret actions of the defendant's principal, Mr. Mastrogiovanni, deprived the plaintiff of any opportunity to attempt to recover its debt from the assets held by Ceramic. Mr. Mastrogiovanni, as I have said, was the alter ego of both companies. His unlawful actions benefited both Tile and Mr. Mastrogiovanni in his personal capacity. Conspiracy is simply an illegal contract.

33 In *Can. Cement LaFarge Ltd. v. B.C. Lightweight Aggregate Ltd.*, [1983] 1 S.C.R. 452, [1983] 6 W.W.R. 385, 21 B.L.R. 254, 24 C.C.L.T. 111, 72 C.P.R. (2d) 1, 145 D.L.R. (3d) 385 at 398 -99, 47 N.R. 191 , Estey J. said the following:

> Although the law concerning the scope of the tort of conspiracy is far from clear, I am of the opinion that whereas the law of tort does not permit an action against an individual defendant who has caused injury to the plaintiff, the law of torts does recognize a claim against them in combination as the tort of conspiracy if:
>
> > (1) whether the means used by the defendants are lawful or unlawful, the predominant purpose of the defendants' conduct is to cause injury to the plaintiff; or,

(2) where the conduct of the defendants is unlawful, the conduct is directed towards the plaintiff (alone or together with others), and the defendants should know in the circumstances that injury to the plaintiff is likely to and does result.

In situation (2) it is not necessary that the predominant purpose of the defendants' conduct be to cause injury to the plaintiff but, in the prevailing circumstances, it must be a constructive intent derived from the fact that the defendants should have known that injury to the plaintiff would ensue. In both situations, however, there must be actual damage suffered by the plaintiff.

34 In *T.L. Raymond Elec. (London) Ltd. v. Idylwild Home Ltd.* (1984), 7 C.L.R. 210 at 219 (Ont. H.C.) , Killeen L.J.S.C. said:

What is clear beyond question, in the modern cases interpreting the Salomon principle is that fraudulent or flagrantly manipulative misconduct on the part of the key owner or owners of the "one-man" type of company will almost invariably lead to an attribution of civil liability against such persons where such misconduct causes financial loss to others: the veil will be pierced because justice and equity demands that such be done.

35 In *Lehndorff Can. Pension Properties Ltd. v. Davis & Co.* (1987), 10 B.C.L.R. (2d) 342, 39 C.C.L.T. 196 (S.C.) , the headnote reads as follows:

Upon authority, if a director acts within the scope of his authority and with good faith, the company is itself liable for any such breach of contract as it may commit, for the act of the director is the act of the company itself. If such director acts in bad faith or outside the scope of his authority, however, he may become personally liable in tort.

36 Mr. Mastrogiovanni, in his individual or personal capacity, caused Ceramic to unlawfully transfer its assets to Tile. He acted then in his individual capacity in that unlawful transfer and he, as well, acted as a director of Tile in the transaction. In doing so, he gave a benefit to himself and to Tile at the expense of the plaintiff.

37 The damage in conspiracy is the injury to the plaintiff, and in this case it is the amount of the debt.

38 I consider the case one of flagrant misconduct where Mr. Mastrogiovanni's secrecy and the circumstances of the transaction are sufficient to call for an award of penal damages. Mr. Mastrogiovanni's testimony did not enhance his position in this regard.

39 I have endorsed the record as follows:

For reasons given this day judgment is to issue against the defendant corporation in terms of paragraphs 9(a) and (b) of the Statement of Claim.

Judgment is to issue against Nicola Mastrogiovanni for

(1) $100,000 plus interest at 11% per annum from 4 April, 1983 to date.

(2) penal damages $10,000.

(3) Costs to the plaintiff against all defendants.

Application allowed.

TAB 9

NO. 586/89

COURT OF APPEAL FOR ONTARIO

McKinlay, Griffiths and Carthy JJ.A.

IN THE MATTER OF the Bankruptcy of OPTICAL RECORDING LABORATORIES INC., of the Municipality of Metropolitan Toronto, in the Province of Ontario

B E T W E E N :	
OPTICAL RECORDING LABORATORIES, INC.	Glenn A. Smith, for the appellant
Debtor (Appellant)	Kevin P. McElcheran and Simon C. Armstrong, for the respondent
- and -	
DIGITAL RECORDING CORPORATION INC.	
	Heard: November 9, 1990
Petitioning Creditor (Respondent)	

GRIFFITHS J.A.:

On the petition of the respondent creditor, Granger J., by judgment dated August 27, 1989, adjudged the appellant debtor bankrupt and issued a receiving order against it finding that the appellant had committed acts of bankruptcy contrary to ss. 42(1)(b) and 42(1)(g) of the Bankruptcy Act, R.S.C. 1970, c. B-3 (as amended). The appellant appeals from the receiving order, contending that the trial judge erred in finding the particular acts of bankruptcy. The respondent cross-appeals, contending that the trial judge erred in failing to go further and find that the appellant had committed, in addition, an act of bankruptcy under s. 42(1)(c) of the Act by creating a fraudulent preference.

THE FACTS

The facts are set out at length in the reasons of the learned trial judge. The following is a summary of those facts pertinent to this appeal.

The appellant, Optical Recording Laboratories, Inc. ("Laboratories"), had a sister company, Optical Recording Corporation ("O.R.C."). Mr. G. John Adamson owned all of the common shares of John Adamson Associates Limited which controlled Laboratories and O.R.C. Adamson was the directing mind of both Laboratories and O.R.C.

On March 28, 1985 the respondent, Digital Recording Corporation Inc. ("Digital"), sold a complete experimental facility known as a Document Storage Development System ("DSDS") to Laboratories for $21,500,000 of which $2,730,000 was paid in cash and the balance of $18,770,000 was secured by a promissory note made by Laboratories in favour of Digital. The promissory note provided that instalment payments on account of principal and interest would not commence until

March 28, 1990 unless there was a default on the part of Laboratories in which case the whole of the principal amount outstanding together with accrued interest thereon would be due and payable immediately. Default under the note would include the following:

1. If Laboratories failed to pay any instalment payment within five days of the due date; or
2. If Laboratories became bankrupt or involved in an insolvency proceeding; or
3. If Laboratories defaulted on any obligation of $100,000 or more which gave the holder of such obligation the right to accelerate payment thereof.

Pursuant to the agreement of March 28, 1985, Laboratories received from Digital the "hard assets", that is, the technology and hardware necessary to undertake research and to develop new products with the DSDS. At the same time as the sale to Laboratories, there was a separate transaction wherein Digital assigned to O.R.C. the patent rights to the technology involved in the DSDS. Under this separate arrangement, O.R.C. was to pay to Digital a certain percentage of royalties received.

On August 31, 1987, Mr. Eli Jacobs (principal shareholder of Digital), Laboratories and O.R.C. entered into a Credit Arrangement whereby Jacobs was to provide Laboratories and O.R.C. with a line of credit up to $500,000 (U.S.). Laboratories and O.R.C. were jointly and severally liable under this agreement and were, pursuant to the agreement, required to pay monthly interest payments on the principal amount owing.

By January, 1988, Laboratories and O.R.C. were indebted to Jacobs under the credit arrangement in the amount of $650,000 (U.S.). On February 12, 1988, Jacobs served Laboratories and O.R.C. with a notice of default under the credit agreement and instituted an action in New York State to recover the amount owing. Jacobs, on behalf of Digital, also took the position that this default under the credit agreement constituted an event of default under the promissory note in that Laboratories had defaulted on an obligation of $100,000 or more. On March 8, 1988, Digital instituted proceedings in the Supreme Court of Ontario against O.R.C. for $18,770,000 plus accrued interest owing on the note.

On April 12, 1988, the action brought by Jacobs in New York State was settled and the amount owing under the credit agreement was satisfied when O.R.C. paid approximately

\$761,000 (U.S.) or \$960,000 (Cdn.) directly to Jacobs. Laboratories purported to treat this payment by O.R.C. as a loan to it by O.R.C. On May 13, 1988, Laboratories executed a general security agreement in favour of O.R.C. purporting to secure the \$761,000 U.S.

On June 30, 1988, Laboratories entered into an asset sale agreement with O.R.C. pursuant to which Laboratories purported to sell all its assets to O.R.C. except the DSDS and a term deposit held in trust for Revenue Canada, for \$1,922,000. The terms of the sale were \$200,000 cash, assumption of \$360,000 of Laboratories' debt and satisfaction of the \$1,362,000 of debt owing by Laboratories to O.R.C.

On July 1, 1988, Laboratories terminated all its employees, who were immediately rehired by O.R.C. Laboratories' research business was then carried on by O.R.C. on premises formerly occupied by Laboratories, using the same employees and facilities to carry on the business previously pursued by Laboratories.

On August 8, 1988, Digital petitioned Laboratories for a receiving order. The trial judge granted the order, holding that Laboratories had committed acts of bankruptcy contrary to what are now ss. 42(1)(b) and 42(1)(g) of the Bankruptcy Act. Those subsections read:

> **42.** (1) A debtor commits an act of bankruptcy in each of the following cases:
>
> (b) if in Canada or elsewhere he makes a fraudulent conveyance, gift, delivery or transfer of his property or of any part thereof;
>
> (g) if he assigns, removes, secretes or disposes of or attempts or is about to assign, remove, secrete or dispose of any of his property with intent to defraud, defeat or delay his creditors or any of them;

The learned trial judge declined to make a finding that Laboratories had committed an act of bankruptcy pursuant to s. 42(1)(c) which reads:

> (c) if in Canada or elsewhere he makes any conveyance or transfer of his property or any part thereof, or creates any charge thereon, that would under this Act be void as a fraudulent preference.

THE FINDINGS OF THE TRIAL JUDGE

The findings of the trial judge may be summarized as follows:

1. That Digital was a creditor of Laboratories within the meaning of s. 2 of the Bankruptcy Act, that is, Digital

was a person having a claim "preferred, secured or unsecured, provable as a claim" under the Act.

2. That the issue of whether the entire sum owing under the promissory note was due must await the trial of the Supreme Court action in Ontario brought by Digital against Laboratories and in which Laboratories denied liability under the promissory note and counterclaimed for damages. The trial judge ruled that, until the issue of what was due under the promissory note was settled in the Supreme Court action, he was not prepared to find that Laboratories had committed a fraudulent preference within the meaning of s. 42(1)(c) of the Bankruptcy Act since proof of the insolvency of Laboratories at the time of the transfer is an essential requisite under s. 95 of the Act. For the same reasons, the trial judge was not prepared to find that Laboratories had committed an act of bankruptcy within the meaning of s. 42(1)(j) of the Bankruptcy Act, that is, had ceased "to meet its liabilities generally as they became due".

3. The general security agreement dated May 13, 1988 and the asset sale agreement dated June 30, 1988 were both fraudulent and constituted acts of bankruptcy within ss. 42(1)(b) and (g) of the Bankruptcy Act.

4. The trial judge found on the evidence that Adamson clearly intended in both instances to protect the assets of Laboratories from "attack by Digital". He concluded that the "timing of the actions" by Laboratories corroborated the expressed intent of Adamson to protect the assets of Laboratories and defeat Digital, the major creditor.

5. With respect to the asset sale agreement of June 30, 1988, the trial judge found that the alleged consideration for this transaction, wherein Laboratories purported to sell not only its hard assets but also its potential ability to generate income from the DSDS, was totally inadequate and that this alleged consideration did not "in any manner breathe legitimacy into the agreement".

6. The trial judge found that, by hiring the former employees and taking over Laboratories' former premises, O.R.C. would continue to use the DSDS and research developed by Laboratories. The trial judge said that he was "convinced beyond any doubt that the transfer was fraudulent and an act of bankruptcy within s. 42(1)(b) of the Bankruptcy Act.

ATTACK ON THE FINDINGS OF THE TRIAL JUDGE

On this appeal, counsel for Laboratories submitted that the trial judge erred in concluding on the evidence that the two transactions constituted fraudulent conveyances. It is submitted that the general security agreement of May 13, 1988 and the asset sale agreement of June 30, 1988 were each entered into for bona fide business purposes and for good consideration.

In arriving at his conclusions, the trial judge made findings of fact that, in my view, were open to him to make on the evidence and an appellate court should not interfere with those findings. The trial judge expressly rejected the position of Laboratories that all of its actions were legitimate business actions and were not fraudulent within the meaning of the Bankruptcy Act. The trial judge found, on the testimony of John Adamson, the directing mind of both Laboratories and O.R.C., that his object in both transactions under attack was to ensure that if the principal sum on the promissory note was due, the income-producing assets developed by Laboratories would be protected from attack by Digital. He found in effect that the timing of the transactions and the lack of "good and valuable consideration" raised general suspicion as to the bona fide of the transactions. The question of whether both transactions were entered into with an intent to defraud creditors is one of fact, to be decided in the particular circumstances of the case. Here, the trial judge concluded in effect that the actions of Laboratories were intended to denude it of all its revenue-producing assets, so that the principal creditor, Digital, could not be repaid. This conclusion was justified on the evidence. The first ground of appeal must fail.

WHETHER THE "CONVEYANCES" CONSTITUTED FRAUDULENT CONVEYANCES IN LAW

Counsel for Laboratories submitted as a central ground of appeal that the trial judge erred in law in making a finding under the Bankruptcy Act that the two transactions in question constituted fraudulent conveyances. Counsel submitted that a fraudulent conveyance within the meaning of s. 42(1)(b) of the Bankruptcy Act and a fraudulent preference within the meaning of s. 42(1)(c) are mutually exclusive categories. Counsel argued that a fraudulent conveyance is a conveyance to a person who is not a creditor of the transferor. A fraudulent preference, it was submitted, by contrast is a conveyance to a person who is a creditor. O.R.C. was a creditor to some extent at the material time and therefore, it was argued, the conveyance to that company would not qualify as a fraudulent conveyance but should only be considered as a possible "fraudulent preference" within the meaning of s. 42(1)(c).

Counsel for Laboratories submits that in order for a conveyance to be considered a fraudulent preference under s. 95 of the Bankruptcy Act, the party challenging the conveyance must prove at the outset that the transferor, Laboratories, was insolvent at the time the conveyance was made. It is submitted that Digital failed to satisfy the trial judge that Laboratories was insolvent at the date of the conveyances and, therefore, the transactions would not constitute fraudulent preferences under the Act.

The only authority that counsel for Laboratories cited in support of the proposition that ss. 42(1)(b) and (g) of the Bankruptcy Act apply only where the transfers or conveyances are made to a third party that is not a creditor, was the following statement contained in The Report of the Ontario Law Reform Commission on The Enforcement of Judgement Debts and Related Matters - Part IV (1983):

> Conceptually, and for the purposes of this chapter, a distinction may be drawn between a fraudulent conveyance and a fraudulent or unjust preference. A fraudulent conveyance is a transfer by the debtor of his property to a third party other than a creditor, whereas a fraudulent preference is a payment by the debtor to one or more, but not all, of his creditors, the transferee or

> transferees being preferred thereby. While the language of the Fraudulent Conveyances Act would seem to comprehend both fraudulent conveyances and fraudulent preferences, the orthodox view is that the Act is restricted to the voiding of fraudulent conveyances.

No case authority was cited for the above proposition. In my view, the distinction drawn by the authors of the Law Reform Commission Report between fraudulent conveyances and fraudulent preferences was drawn solely for the purpose of the discussion that followed in the ensuing chapter.

Although the Bankruptcy Act is the governing federal legislation, it has long been recognized that creditors are entitled to make use of the rights and remedies provided under provincial legislation to the extent that such legislation is not in conflict with the Bankruptcy Act: see Re Panfab Corp. Ltd., [1971] 2 O.R. 202 at p. 207 per Houlden J.

The two provincial statutes that operate concurrently in the area of fraudulent transfers are the Fraudulent Conveyances Act, R.S.O. 1980, c. 176 and the Assignments and Preferences Act, R.S.O. 1980, c. 33.

There is no definition of "fraudulent conveyance" in the Bankruptcy Act. Under the Fraudulent Conveyances Act, a debtor makes a "fraudulent conveyance" if he makes a "conveyance" of property "with intent to defeat, hinder, delay or defraud creditors or others of their just and lawful actions" (s. 2) [Emphasis added]. By s. 1(a), the term "conveyance" includes a "charge" on the debtor's property and, accordingly, the general security agreement of May 13, 1988 executed by Laboratories in favour of O.R.C. would qualify as a "conveyance".

The provisions of the Fraudulent Conveyances Act defining a fraudulent conveyance in no way limit such transactions to conveyances to third parties other than creditors. In my view, there is no rational reason to read into the legislative definition such a restrictive interpretation. The legislation, being remedial, should be given a liberal construction.

The author Dunlop, in his textbook Creditor-Debtor Law in Canada (1981), at p. 513 states the purpose of fraudulent conveyance legislation as follows:

> The purpose of the Statute of Elizabeth and of the Canadian Acts based on it, as interpreted by the courts, is to strike down all conveyances of property made with the intention of delaying, hindering or defrauding creditors and others except

> for conveyances made for good consideration and bona fide to persons not having notice of such fraud. The legislation is couched in very general terms and should be interpreted liberally. Lord Mansfield concluded that the common law had always been strongly against fraud in every shape and that the Statute of Elizabeth "cannot receive too liberal a construction, or be too much extended in suppression of fraud". Relying on this policy, the courts have interpreted the statute to include any kind of alienation of property made with the requisite intent, the form of the transaction being immaterial. Similarly the legislation has been held to invalidate a conveyance of any kind of exigible or attachable property of the debtor, so long as it is of some real value. [Emphasis added.]

In my view, in determining whether a conveyance is fraudulent under ss. 42(1)(b) or (c) of the Bankruptcy Act, it is irrelevant whether the transfer was made to a creditor. Instead, what is germane to such an inquiry is the genuineness of the conveyance. To this end, s. 3 of the Fraudulent Conveyances Act precludes the impeachment of a conveyance "upon good consideration and bona fide to a person not having at the time of the conveyance to him notice or knowledge of the intent set forth in s. 2" (i.e., to defeat, hinder, delay or defraud creditors ...). If the argument of Laboratories were correct, debtors could avoid a finding of fraudulent conveyance, under the Fraudulent Conveyances Act, even though they conveyed assets intending to defeat, hinder or delay their creditors so long as the recipient of the conveyance was a creditor for any amount, no matter how nominal. In my view, if such a limitation were intended, then it would surely have been expressly stipulated in the legislation.

This second ground fails and, accordingly, the appeal must be dismissed.

THE CROSS-APPEAL

In the cross-appeal, counsel for Digital submits that the learned trial judge erred in failing to find that the sale under the asset sale agreement of June 30, 1988 from Laboratories to O.R.C. was a transfer of property between a debtor and a creditor made within three months of the date of the petition for the receiving order. Counsel argues it was therefore void as a fraudulent preference under s. 95 of the Bankruptcy Act because (a) Laboratories was insolvent at the time of the transfer; (b) the transferee, O.R.C., was a creditor; and (c) the transfer had the effect of giving that creditor a preference over other creditors such as Digital.

There is no question that conditions (b) and (c) are satisfied in the light of the findings of the trial judge. As the trial judge said:

> If the sum of $18,770,000 plus accrued interest was due when O.R.L. [Laboratories] entered into the asset sale agreement, such agreement would have been a transfer by an insolvent company providing a creditor with a preference and therefore deemed fraudulent and void, as made within three months of the bankruptcy.

However, the trial judge declined to make a finding that the sum of $18,770,000 was owing on the promissory note at the material time and that Laboratories was therefore insolvent. He directed his mind to s. 42(1)(j) of the Bankruptcy Act which provides:

> **42.** (1) A debtor commits an act of bankruptcy in each of the following cases:
>
> (j) if he ceases to meet his liabilities generally as they become due.

The trial judge held that the issue of whether or not the sum of $18,770,000 was a liability that had become due must await the outcome of the Supreme Court action brought by Digital against Laboratories for recovery of that sum under the note. In that respect, he said:

> That action, however, is for a determination as to whether or not the actions of O.R.L. [Laboratories] constituted a default under the promissory note and thereby rendered the total amount owing, not whether Digital has a claim against O.R.L. The unliquidated amount of damages O.R.L. alleges are due to it under the

> counterclaim cannot be set off against Digital's claim and do not affect Digital's status as creditor. Accordingly Digital has status to bring this petition.

Counsel for Digital submits that the trial judge erred in limiting his consideration to the issue of whether Laboratories was insolvent in the sense that it had ceased to meet its liabilities generally as they became due as at May 13, 1988 under s. 42(1)(j) of the Bankruptcy Act. Counsel submits that the 1987 and 1988 financial statements filed at trial demonstrate that Laboratories had approximately $400,000 of assets at the time and liabilities in excess of several million dollars made up substantially of the debt owing to Digital. It was submitted that the trial judge should have directed his attention to the definition of "insolvent person" as defined by s. 2(c) of the Act as follows:

> "insolvent person" means a person who is not bankrupt and who resides or carries on business in Canada, whose liabilities to creditors provable as claims under this Act amount to one thousand dollars, and
>
> . . .
>
> (c) the aggregate of whose property is not, at a fair valuation, sufficient, or, if disposed of at a fairly conducted sale under legal process, would not be sufficient to enable payment of all his obligations, due and accruing due.

In my respectful view, the learned trial judge erred in failing to make a finding of insolvency within the meaning of the definition in s. 2(c). At the material time of the petition, the financial statements filed in the proceedings clearly established that the liabilities of Laboratories far exceeded its assets. In its evidence at trial, Adamson admitted that the obligation of $18,770,000 plus interest <u>was owing</u> but disputed whether it was due. In the Supreme Court action brought in Ontario, the counterclaim of Laboratories was for a sum of approximately $200,000 damages. Whatever success Laboratories might enjoy in the pending Supreme Court action, it seems to me improbable that its liabilities on the promissory note, which are now in excess of $23,000,000, would be reduced to a point where its assets at any fair valuation would be sufficient to meet those liabilities. It must not be overlooked, as well, that the trial judge earlier found that Laboratories was a "creditor" of Digital and this finding could only be supported on the basis that money was owing to Digital under the promissory note.

Accordingly, I would allow the cross-appeal and vary the judgment below to include a finding that the appellant committed an act of bankruptcy as well, contrary to s. 42(1)(c) of the <u>Bankruptcy Act</u> by making a conveyance of its property and creating a charge thereon that would, under the Bankruptcy Act, be void as a fraudulent preference.

THE RESULT

In the result, then, the appeal is dismissed with costs. The cross-appeal is allowed without costs.

[illegible] J.A.

I agree [illegible] J.A.

I agree [illegible] J.A.

NO. 586/89

COURT OF APPEAL FOR ONTARIO

McKinlay, Griffiths and Carthy JJ.A.

B E T W E E N :

OPTICAL RECORDING LABORATORIES, INC.

Debtor
(Appellant)

- and -

DIGITAL RECORDING CORPORATION INC.

Petitioning Creditor
(Respondent)

J U D G M E N T

RELEASED: December 17, 1990

McKinlay J.A.

20

TAB 10

Most Negative Treatment: Reversed
Most Recent Reversed: Dougmor Realty Holdings Ltd., Re | 1967 CarswellOnt 56, 11 C.B.R. (N.S.) 153, 65 D.L.R. (2d) 419, [1968] 1 O.R. 61 | (Ont. C.A., Oct 11, 1967)

1966 CarswellOnt 31
Ontario Supreme Court

Dougmor Realty Investments Holdings Ltd., Re

1966 CarswellOnt 31, [1967] 1 O.R. 66, 10 C.B.R. (N.S.) 141, 59 D.L.R. (2d) 432

Re Dougmor Realty Holdings Limited; Fisher v. Wilgorn Investments Limited

Lieff J.

Judgment: October 13, 1966

Counsel: *M. B. Page*, for plaintiff.
F. S. Weatherston, Q.C., for defendant.

Subject: Corporate and Commercial; Insolvency; Contracts; Torts; Civil Practice and Procedure
Related Abridgment Classifications
Bankruptcy and insolvency
XI Avoidance of transactions prior to bankruptcy
XI.2 Fraudulent preferences
XI.2.b What constituting preference
XI.2.b.ii Whether transaction occurring in debtor-creditor relationship
Civil practice and procedure
XX Trials
XX.7 New trial
XX.7.a Grounds for granting
XX.7.a.vi Miscellaneous
Debtors and creditors
XII Fraudulent conveyances
XII.11 Practice and procedure
XII.11.f Burden of proof
XII.11.f.i General principles
Headnote
Bankruptcy --- Avoidance of transactions prior to bankruptcy — Fraudulent preferences — What constituting preference — Whether transaction occurring in debtor-creditor relationship
Fraud and Misrepresentation --- Fraudulent conveyances — Practice and procedure — Burden of proof — General
Practice --- Trials — New trial — Grounds for granting — General
Fraudulent conveyances — Conveyance of land from bankrupt company to associated company within three months of bankruptcy — The Bankruptcy Act, R.S.C. 1952, c. 14, s. 64 — Necessity that "creditor" receive a preference — The Fraudulent Conveyances Act, R.S.O. 1960, c. 154, ss. 2, 3, 4 — Burden of proof — Conveyance declared fraudulent as against trustee.
A conveyance of property from D. Limited, to W. Limited, was dated 31st May 1965, and was registered on 3rd June 1965. A petition was filed against D. Limited on 24th August 1965, and a receiving order was subsequently made. The trustee in bankruptcy of D. Limited attacked the conveyance under the provisions of s. 64 of the Bankruptcy Act and under The Fraudulent

Conveyances Act. In the trial of an issue wherein the trustee was plaintiff and W. Limited was the defendant, evidence was submitted on behalf of the plaintiff but the defendant called no witnesses.

Held, since it was not established that W. Limited was the creditor and D. Limited was a debtor, the plaintiff could not succeed under the provisions of s. 64 of the Bankruptcy Act. However, the conveyance should be declared fraudulent and void as against the plaintiff under the provisions of The Fraudulent Conveyances Act.

1. All the circumstances of the transaction must be investigated before arriving at a decision, and in particular, the manner in which the property came into the hands of the grantee. A number of questions must be decided: (a) did the transaction defeat, hinder, and defraud the creditors? (b) was the conveyance a voluntary one or was it for valuable consideration? (c) if it was voluntary, was the asset transferred a substantial one? (d) if it was for valuable consideration, was it adequate consideration? (e) was this a *bona fide* transaction? (f) did the grantee participate in the fraudulent intent? In considering whether the conveyance made by D. Limited was made to "defeat, hinder and defraud" it must be considered whether or not this was a voluntary deed or one for valuable consideration. If it was voluntary, then the law presumed that the grantor intended to defraud his creditors and the onus shifted to him to rebut that presumption. In this particular case, the conveyance was not voluntary. The grant showed on its face that the consideration was "other valuable consideration and the sum of $1.00". The land transfer tax affidavit stated that "securities to the value of $97,000.00" was the true amount or the value of the consideration. An earlier affidavit sworn by the same person who swore the land transfer tax affidavit stated that the conveyance was made "merely to convey to the grantee lands of which it was the real beneficial owner". The contradictory evidence was suspicious and failure to produce evidence as to the actual value of the consideration and/or the land was unexplained (*Levy v. Creighton* (1874), 22 W.R. 605, referred to).

2. The phrase "valuable consideration" can mean an "approximately adequate consideration". It may also mean money or its equivalent or something worth money. The adequacy of the consideration will be an element in deciding whether there has been fraud. In this case, on the balance of probabilities, it could not be found that the transfer was made *bona fide* and for valuable consideration. Consequently the question arose, how much did the plaintiff have to prove before the burden of producing evidence shifted?

3. Since both D. Limited and W. Limited had the same president and also the other directors were common to both companies, and generally in view of the close relationship between the two companies and the various suspicious circumstances, the burden of producing evidence had shifted. Accordingly, it had to be presumed that W. Limited participated in any fraudulent intent of D. Limited.

4. The phrase *"bona fide"* ought to be taken to mean a sale to a real purchaser and not merely a nominee or put in another way, the transaction must be more than a form of purchase. The phrase *"bona fide"* signified something done in good faith without fraud, or deceit or collusion. There must be honesty in fact and complete frankness. In respect of s. 3 of The Fraudulent Conveyances Act, while the overall onus rested on the plaintiff to the end, nevertheless, there was a duty to testify or adduce evidence and to present to the court for its scrutiny all the information as to consideration within the knowledge of the purchaser. The burden of proof in the proceedings lay at first on the party against whom the judgment of the court would be given if no evidence were produced on the other side. In other words, the burden of proof as to any particular fact, lay on the person who wished the court to believe in the existence of that fact. To entitle W. Limited to the benefit of s. 3 of The Fraudulent Conveyances Act, W. Limited must adduce evidence of the actual payment of the moneys independently of the recitals in the deed and the land transfer tax affidavit. The burden to prove his case is always on the plaintiff whether the defendant introduces evidence or not, but in a situation where the question of fraud is paramount there is a duty to adduce evidence and this W. Limited and D. Limited did not do (*Koop v. Smith* (1915), 51 S.C.R. 554 at 558, 8 W.W.R. 1203, 25 D.L.R. 355, applied).

The suspicious circumstances coupled with close relationship (in this case between D. Limited and W. Limited) made a sufficient *prima facie* case.

Annotation

This case was decided on The Fraudulent Conveyances Act and not on the Bankruptcy Act and, in view of the rather suspicious circumstances coupled with the close relationship of the parties, Lieff J. came to the conclusion that the conveyance in question was fraudulent and should be set aside.

This case involved a very thorough research of the authorities involved and will be of great importance to trustees who intend to set aside fraudulent transactions when a "debtor-creditor" relationship is non-existent.

In order to have a transaction set aside under s. 64 of the Bankruptcy Act, it is, of course, necessary that the respondent be a "creditor" of the bankrupt.

It would appear that, since this case was decided on The Fraudulent Conveyances Act, that certain pronouncements with regard to the Bankruptcy Act — with the exception that the "debtor-creditor" relationship is necessary to have a transaction set aside under s. 64 — would appear to be *obiter dicta*. However, the statement that "the trustee must prove that the grantor intended to create a preference and the grantee in turn intended to receive a preference" should be read with some caution because s. 64(2) creates a presumption that, if the debtor is insolvent at the time the transaction was entered into, and the transaction occurred within the three month period mentioned in the section, and the effect was to give a preference to a particular creditor, then the transaction was done "with a view to giving such creditor a preference over other creditors". See *Re Blenkarn Planer Limited* (1958), 37 C.B.R. 147 at 148, 149, 26 W.W.R. 168, 14 D.L.R. (2d) 719, 3 Can. Abr. (2nd) 2600. It is possible that Lieff J. wished to make it clear that "the Court must be satisfied that the grantor intended to create a preference and the grantee in turn intended to receive a preference" which would imply that the court is accepting the requirement for concurrent intent, as has been done in several decisions in Ontario.

A number of decisions of the Ontario Court of Appeal make it clear that the burden of proof to establish the legality or illegality of the "preference" does not lie on the trustee but on the creditor who received the preference: see for example, *Re Fifth Avenue Cloak Co.; Trustee v. Krangle* (1934), 15 C.B.R. 504 at 511, 3 Can. Abr. (2nd) 2645; *Briscoe v. Molsons Bank* (1922), 51 O.L.R. 644 at 648, 4 C.B.R. 194, 69 D.L.R. 675, 3 Can. Abr. (2nd) 2675; *Re Eaman; Foote, Trustee v. Gilchrist Lbr. Co.*, [1937] O.W.N. 317, 18 C.B.R. 336, 3 Can. Abr. (2nd) 2648; *Re Chamandy & Sons Ltd.; Trustee v. Aboud* (1933), 14 C.B.R. 458 at 459, 3 Can. Abr. (2nd) 2644; *Re Irwin* (1948), 29 C.B.R. 142 at 143, 3 Can. Abr. (2nd) 2655.

It seems to be settled law that under s. 64 of the Bankruptcy Act the trustee is required to prove (1) that the debtor was insolvent at the time that the transaction took place. This does not require proof beyond a reasonable doubt but only the usual proof in civil cases; (2) that the transaction must have taken place within three months of the bankruptcy; (3) that the effect of the transaction must be that the creditor received a preference. When the trustee has proved these facts, a presumption is then raised that the transaction was made with a view of giving a creditor a preference.

***Lieff J.*:**

1 A receiving order was made against Dougmor Realty Holdings Limited (to whom I shall here inafter refer as "Dougmor") on the 29th September 1965, by McDermott J., the petition having been filed on 24th August 1965. By further order of McDermott J. it was ordered that the trustee in bankruptcy, one, Oscar Fisher, C.A., and Wilgorn Investments Limited (to whom I shall hereinafter refer as "Wilgorn") proceed with the trial of an issue to ascertain whether there has been a fraudulent conveyance from Dougmor to Wilgorn, which conveyance is dated the 31st May 1965, and was registered in the registry office for the registry division of the County of Halton (for Burlington) on 3rd June 1965, as No. 184277.

2 No pleadings were filed nor were any examinations held. Evidence was submitted on behalf of the plaintiff but the defendant called no witnesses. Counsel for the plaintiff initially took the position that the transaction amounted to an illegal preference and therefore he need only prove three things in order to shift the onus of explanation to the defendant, namely:

3 (a) that the debtor, Dougmor, was insolvent at the time of the grant;

4 (b) that the conveyance was given within three months of the bankruptcy; and

5 (c) that the effect of the transaction was to prefer a creditor.

6 In support of this proposition, I was referred to the case of *Re Blenkarn Planer Ltd.* (1958), 37 C.B.R. 147, 26 W.W.R. 168, 14 D.L.R. (2d) 719, 3 Can. Abr. (2nd) 2600, from which decision I concluded that the trustee must prove that the grantor intended to create a preference and the grantee in turn intended to receive a preference.

7 The evidence was short and in my opinion not as complete as it might have been. I shall review it briefly.

8 One, Morris Krandell, a chartered accountant, associated with the trustee in bankruptcy, testified that in the course of his duties he investigated the affairs of Dougmor. He made a detailed examination of the books of the company with special reference to the period of May and June 1965. When he undertook the investigation of the books they were not current and had to be written up. He also examined a statement of affairs of the company prepared by one, Stettins, for the period ending 31st December 1964. From an examination of that statement of affairs this witness concluded that the company could not meet its obliga tions. The statement was not put in evidence, but briefly it indicated that the company had current assets at that time of $210,000 of which $14,000 was a receivable from Dougmor, an associated company, which, in the light of recent events, is said to be an account that is proving difficult to collect. I did not see a statement of liabilities. This witness gave his opinion, after examining the books for the months of May and June 1965, that the company could not meet its obligations at that time as it was insolvent. At all events he stated that the creditors were not being paid. He inferred from the books that there were not sufficient assets to pay secured or unsecured creditors during that period and particularly around the 1st of May 1965.

9 The company was engaged in the construction of a building financed by mortgage moneys provided by the Crown Life Assurance Company. On 28th May 1965, Crown Life advanced a "final draw" of $108,000 which was paid out to various creditors upon the direction of the borrower.

10 The president of Dougmor is one, William Morris, and he is also president of Wilgorn. The lands which were conveyed by deed No. 184277 were acquired by Dougmor in two transactions. The first one was closed on 25th April 1965, and was a sale from one, Brown, for $42,000, and the second transaction was closed on 17th May 1965, and this was a sale from one Stark, for a purchase price of $5,000. Apart from the deposit paid on these transactions, namely, $3,500, which deposit was paid by Dougmor, the purchase price for both parcels was provided by Philip and Benjamin Rosenblatt who advanced $55,000 and took back a first mortgage on the lands from Dougmor to Rosenblatt. The transaction is reflected in the books of Dougmor. At the time of the bankruptcy the apartment was about 95 per cent. completed. The debtor knew then that he required further financing to complete the building and it was given in evidence that at one time he had a commitment for a second mortgage of $100,000 but that mortgage transaction did not materialize because mechanics' liens were filed against the property, which liens could not be removed from the title.

11 Wilgorn does not appear on the books of the company as a creditor, nor is there any evidence anywhere indicating a liability by Dougmor to Wilgorn, other than contained in para. 6 of the affidavit of W. Morris. This in my view is not conclusive evidence.

12 One, Martin Johnston Hutton, acted as solicitor for both Dougmor and Wilgorn in the preparation of the deed, the provision of first mortgage funds and I assume he acted generally as counsel for both corporations as well as for the Rosenblatts. The lands in question were acquired before the end of May 1965 with the mortgage moneys obtained from Rosenblatt, which funds were disbursed to the vendor with a small balance being paid to Dougmor.

13 One, Chester Wasiuk, a creditor of Dougmor, testified that he was president of Toronto Flooring Limited, a company which had supplied and installed hardwood flooring in the apartment building. During the months of April and May he had been working at the apartment site and about the middle of May Dougmor owed Toronto Flooring Limited approximately $5,500. Morris, had promised to pay this amount, but by the end of May Wasiuk had received no moneys on account of this indebtedness. However, he did receive a cheque for $5,000 on 26th May which cheque was not paid. On 8th June Wasiuk received the sum of $800 on account and he testified that Morris had told him that he did not have sufficient moneys to cover the whole cheque. Eventually, Morris asked Wasiuk to return the $5,000 cheque to him. A little later Wasiuk was present at an informal meeting of creditors at which a creditors' committee was established of which Wasiuk became a member. At one of the subsequent creditors' meetings, Morris told the creditors present that he was in a difficult position and he wanted some assistance from the creditors. He said that he would give the creditors some security, namely, a second mortgage on the apartment building as well as on the lands in question in this action. It is important to note at that time that Morris told this witness and others that he was in a bad position and that he would not be able to complete the construction of the apartment building unless he received help from the creditors. He said that *eventually* (emphasis mine) the creditors would receive 100 cents on the dollar. I believe this witness when he stated that Morris had told the creditors' meeting that *Morris could not meet his obligations at that time and that he needed help from them*.

14 It is interesting to note that at the meeting nobody learned exactly how much the debtor owed, but at a subsequent meeting it was ascertained that he owed about $225,000, and that he also required further moneys to complete the building.

15 One, Herbert Fruitman, an officer of Toronto Electric Limited, and a creditor in the sum of $1,600 testified that during May 1965 he too attended a meeting of creditors. He had difficulty collecting his account of $1,600 and he too received a cheque on account of the indebtedness in the sum of $1,200 which cheque was never paid. The last informal meeting of creditors took place in July 1965. Morris also told this witness that he did not have sufficient moneys to pay his creditors and that unless he gave him a longer time to pay, the creditors would get nothing out of their accounts against Dougmor. Morris told the creditors' meeting that they would not receive 100 cents on the dollar unless the building was finished and unless Dougmor got the help that he was asking of the creditors, he was bankrupt.

16 In addition to the oral testimony, a number of exhibits were filed consisting of mortgage statements, deposit cheques, and a certified copy of the deed in question.

17 Reference was made to affidavits that had been filed in support of the motion which resulted in the order for the trial of this issue.

18 The question for decision as propounded initially by counsel for the plaintiff is whether this transaction was a fraudulent preference within the meaning of the Bankruptcy Act, s. 64(2). The defendant took the position that there was no creditor/debtor relationship between the two companies and there was no money owing by Wilgorn to Dougmor or *vice versa*. I find that the questioned transaction took place within three months prior to the bankruptcy and I find also that the debtor could not pay his liabilities as they fell due. The defendant was admittedly short of cash, but counsel for Dougmor stated that unless the witness Krandell was in a position to place a value on the apartment building as of June 1965, he was not in a position to state whether Dougmor was insolvent or not. Section 64(1) of the Bankruptcy Act uses the phrase "in favour of any creditor or ... in trust for any creditor".

19 A creditor is defined by the Bankruptcy Act as a person having a claim, preferred, secured or unsecured, provable as a claim under the Bankruptcy Act.

20 To establish that there was a fraudulent preference within the meaning of the Bankruptcy Act, I must find that Wilgorn was a creditor and Dougmor a debtor. This was not proven. I find therefore that it was not an illegal preference under s. 64(1) of the Act.

21 At my request counsel, at a later date, argued whether this transaction was fraudulent for some other reason, and particularly under The Fraudulent Conveyances Act.

22 For the plaintiff I was referred to The Fraudulent Conveyances Act, and some case law which I shall now consider.

23 Sections 2, 3 and 4 of The Fraudulent Conveyances Act, read as follows:

> 2. Every conveyance of real property or personal property and every bond, suit, judgment and execution heretofore or hereafter made with intent to defeat, hinder, delay or defraud creditors or others of their just and lawful actions, suits, debts, accounts, damages, penalties or forfeitures are void as against such persons and their assigns.
>
> 3. Section 2 does not apply to an estate or interest in real property or personal property conveyed upon good consideration and *bona fide* to a person not having at the time of the conveyance to him notice or knowledge of the intent set forth in that section.
>
> 4. Section 2 applies to every conveyance executed with the intent set forth in that section notwithstanding that it was executed upon a valuable consideration and with the intention, as between the parties to it, of actually transferring to and for the benefit of the transferee the interest expressed to be thereby transferred, unless it is protected under section 3 by reason of *bona fides* and want of notice or knowledge on the part of the purchaser.

24 For the plaintiff I was also referred to a series of cases, principally, *Owen Sound Gen. and Marine Hospital v. Mann*, [1953] O.R. 643, [1953] 3 D.L.R. 417; *Koop v. Smith* (1915), 51 S.C.R. 554, 8 W.W.R. 1203, 25 D.L.R. 355; *Caulfield, Burns and Gibson Ltd. v. Kitchen*, [1956] O.W.N. 697, 36 C.B.R. 59, 5 D.L.R. (2d) 669.

25 The plaintiff urged that the transfer of the lands in question was a transfer of an asset which defeats the trustee. The defendant took the position that the burden of proof was on the plaintiff and that burden was not satisfied. In support of that position it was argued by counsel for the defendant that during May insolvency was not necessarily imminent although the grantor was insolvent in July. He said that Morris had some ground for believing that "with some luck" he could pull through during the month of May. He argued also that there was no evidence before me that Dougmor had fewer assets than liabilities during the month of May, nor that Morris knew that Dougmor was going into bankruptcy at that time. It was submitted that the value of the property as set out in the land transfer tax affidavit would be good evidence of value. I am not impressed with the argument as to value because the affidavit is only that of Mr. Morris.

26 The defendant cited, amongst others, the following cases: *Hopkinson v. Westerman* (1919), 45 O.L.R. 208 at 214, 48 D.L.R. 597, in which Middleton J. states that the plaintiff must show a fraudulent intention which must be established by evidence in each case; *Carr v. Corfield* (1890), 20 O.R. 218, 3 Can. Abr. (2nd) 2722, in which Street J. stated "fraudulent intention is material". Mr. Weatherston also argued that the mere fact that the result of the transaction defeats the creditors is no proof that the intention of the person making it is fraudulent. See *Godfrey v. Poole* (1883), 13 App. Cas. 497 at 503.

27 It is clear from the cases that all the circumstances of the transaction must be investigated before arriving at a decision, and in particular the manner in which the property came into the hands of the grantee.

28 A number of questions must be decided.

29 (1) Did the transaction defeat, hinder and defraud the creditors?

30 (2) Was the conveyance a voluntary one or was it for valuable consideration?

31 (3) If it was voluntary, was the asset transferred a substantial one?

32 (4) If it was for valuable consideration, was it adequate consideration?

33 (5) Was this a *bona fide* transaction?

34 (6) Did the grantee participate in the fraudulent intent?

35 In considering whether the conveyance made by Dougmor was made to "defeat, hinder and defraud" I must consider whether or not this was a voluntary deed or one for valuable consideration. If it was voluntary, then the law presumes that the grantor intended to defraud his creditors and the onus shifts to him to rebut that presumption.

36 Was this grant of land given for that purpose?

37 I find on the evidence that the conveyance was not voluntary. Having so found, I am not required to decide whether the asset was a substantial one, although quite obviously it was.

38 Was the conveyance for valuable consideration?

39 The question of consideration being all important it is incumbent upon me to examine all the aspects of the case. See *Goldsmith v. Russell* (1855), 5 De G.M. & G. 547 at 555, 43 E.R. 982. In that case the conveyance was set aside because apart from other suspicious circumstances there was much contrivance to show that the settlement was for value when it was not.

40 In the case at bar, the grant shows on its face that the consideration is "other valuable consideration and the sum of $1.00". In the land transfer tax affidavit sworn by Morris, the president of both the grantor and grantee companies, (and corrected by

striking out the name of the solicitor), it is stated that "securities to the value of $97,000.00" is the true amount or the value of the consideration. That valuation has not been reflected in the books of Dougmor and the evidence makes no further mention of consideration except in para. 6 of an affidavit dated 13th December 1965, filed on the original motion herein in which Morris testifies that the conveyance was made "merely to convey to the grantee lands *of which it was the real beneficial owner"*. The affidavit of land transfer tax therefore seems to contradict the affidavit of 13th December 1965. I find it significant that no reference to a debtor-creditor relationship between Dougmor and Wilgorn appears in the books of Dougmor. It is difficult indeed to find that there is present here what s. 3 of the Fraudulent Conveyances Act refers to as good consideration. The contradictory evidence in this instance raises another suspicious circumstance.

41 Was the consideration adequate? It may well be that it is. But here too the only thing I am sure of is the original purchase price of the property which was purchased a few months earlier for $42,000 and it may very well be that $97,000 represents a fair value of the land at the date of the Wilgorn deed. It may also be that the sum of $42,000 which was paid for the land was a sacrifice or bargain price. The court was left to guess at the real value of the property. The statement on the face of the deed that the consideration was $1 and other good and valuable consideration offers little, if any, help. The transfer of securities mentioned in the land transfer tax affidavit is not convincing evidence as to what the real value of the property is and I cannot find that it is either adequate or inadequate. There is no evidence as to the nature of the said securities or the time and manner of their transfer. If they were transferred to Dougmor there is no evidence before me that even the fact of transfer is reflected in the Dougmor books. I saw no transfer register or minute books.

42 Did these securities form part of the assets of Dougmor which later should have come into the hands of the trustee in bankruptcy? If they did in fact reach the trustee in bankruptcy and if they were in fact worth $97,000, then in all probability this application need never have been brought.

43 Another perplexing problem relating to consideration is the factual one of whether or not the Rosenblatt mortgage was registered against the property when it was transferred to Wilgorn. Conceivably that could have provided sufficient consideration to make the transaction one for valuable consideration. The evidence in that regard is also inadequate. Paragraph 3(*d*) of the land transfer tax affidavit annexed to the deed in question reads as follows:

> 3(*d*) Balance of existing encumbrances with interest owing at the date of transfer ... $ nil.

44 Paragraph 3(*e*) of the same affidavit reads as follows:

> 3(*e*) Monies secured by mortgage under this transaction ... $ nil.

45 Where a property against which a mortgage is registered is transferred the transferee is obligated to pay the moneys due under the terms of the mortgage. The body of the deed makes no mention of an existing mortgage, or its assumption by the grantee. Had the mortgage to Rosenblatt been paid off? The evidence does not say. This is another unexplained suspicious circumstance.

46 The failure to produce evidence as to the actual value of the consideration and/or the land is unexplained. In this connection, the reasoning of James L.J. in *Levy v. Creighton* (1874), 22 W.R. 605, commends itself to me and particularly the following words:

> It really must be proved beyond a shadow of a doubt that there was that additional consideration which the parties did not choose to put on the face of the instrument.

47 The phrase "valuable consideration" can mean an "approximately adequate consideration." It may also mean money or its equivalent or something worth money. The adequacy of the consideration would be an element in deciding whether there has been fraud. The evidence is silent as to the real value of the property at the time of the transfer to Wilgorn or whether the sale price was disproportionate to its real value.

48 Some of the cases discuss suspicious circumstances as a factor.

49 The case of *Koop v. Smith, supra*, is pertinent and commends itself to me at this juncture. The headnote reads [S.C.R.]:

> Where a bill of sale made between near relatives is impeached as being in fraud of creditors and the circumstances attending its execution are such as to arouse suspicion the court may, as a matter of prudence, exact corroborative evidence in support of the reality of the consideration and the *bona fides* of the transaction.

50 In the reasons for his decision in this case, Duff J. (as he then was) used the following language at p. 558 of the report:

> I may add that I think it doubtful whether the Ontario decisions when properly read really do lay it down as a rule of law that the fact of relationship is sufficient in itself to shift the burden of establishing the burden of proof in the strict sense. It may be that the proper construction of these cases is that the burden of giving evidence and not the burden of the issue is shifted .... In my own view, as indicated above, even this would be putting the matter just a little too high; I think the true rule is that suspicious circumstances coupled with relationship make a case of *res ipsa loquitur* which the tribunal of fact may and will generally treat as a sufficient *prima facie* case, but that it is not strictly in law bound to do so; and that the question of the necessity of corroboration is strictly a question of fact.

51 It is to be noted, therefore, that in connection with fraudulent conveyances, the phrase *res ipsa loquitur* describes a situation where the facts themselves suggest a *prima facie* case of fraud which shifts the evidentiary burden to the defendant.

52 The case of *Walker v. Burrows* (1745), 1 Atk. 93, 26 E.R. 61, is also interesting in this connection. That case was based on the following facts.

53 B., in 1718 after marriage, conveys his real estate to trustees, in consideration of five shillings and other valuable considerations, in trust for himself for life, to his wife for life, then to his eldest son if he survived his father and mother and so to the next son etc. B. afterwards became bankrupt.

54 In his judgment, Lord Hardwicke commented on the evidentiary problems connected with consideration in the following way, at p. 94:

> It has been said, I must at this time take the deed in 1718 to be for a valuable consideration, because expressed to be for five shillings and other valuable considerations.
>
> But the consideration of five shillings, and other valuable considerations, does not oblige the court to hold it, at all events, to be for a valuable consideration, *and can at most only let the defendant into proof that there were other valuable considerations*.

(The italics are mine.)

55 A statement to the same effect is found in May on Fraudulent Conveyances, 2nd ed., 1887, at p. 249.

56 I seem to be in a position exactly analagous to that of Lord Hardwicke in *Walker v. Burrows, supra*, because the deed in that case expresses the consideration to be $1.00 and other valuable consideration.

57 On the question of onus in circumstances such as these or in this particular issue, I have not been able to find any authority directly on point. However, two oblique suggestions lead me to the conclusion that in circumstances which excite the trial judge's suspicions the onus of adducing evidence is on the grantor. The first suggestion comes from the words of Lord Hardwicke himself. It will be recalled that he had decided that a statement by the defendant that valuable consideration was paid "can at most only let the defendant into proof that there were other valuable considerations". The second basis for this conclusion is the treatment of the analagous position where a deed on its face is made for good, that is, meritorious consideration, but not for valuable consideration.

58 James L. J. in *Levy v. Creighton, supra*, at p. 606 has the following to say:

> It was said, however, that there was an additional consideration for that settlement which was not expressed. No doubt there were cases both in the Court of Chancery and at Common Law (which were very difficult to understand) in which when a deed purported to be merely a voluntary settlement for natural love and affection, you could, in addition to the deed, but not in contradiction of it, give evidence of some other consideration. The transaction purporting to be represented by an entire instrument, a man conveyed his estate for natural love and affection, and then it was said there was some other consideration. However, that was the rule in law and in equity, that you could give evidence of that other consideration. *But that evidence must be to the utmost extent satisfactory and conclusive. It really must be proved beyond the shadow of a doubt that there was that additional consideration which the parties did not choose to put on the face of the instrument*.

(The italics are mine.)

59 See also *Rada v. Kalina*, [1950] O.W.N. 299, [1950] 2 D.L.R. 666. In that case the plaintiff sued on behalf of himself and other judgment creditors.

60 The male defendant had conveyed to the female defendant, his common-law wife, two properties. The first deed showed the consideration to be "natural love and affection and the sum of one dollar". However, the male defendant swore that he received some $3,200 or $3,400 for the property. The second deed was expressed to be for the sum of $1,700. The male defendant swore that in fact he had received $2,500 for the property.

61 Hope J.A. stated at p. 300 that:

> ... although a conveyance purports to be made in consideration of natural love and affection, evidence may properly be adduced to show that there was some other consideration.

62 The learned Judge went on to say that difficulty in meeting obligations was one element *"which leads to the prima facie presumption of intent to defraud."* (The italics are mine). He noted however, that the trial judge had not found any scheme to defraud creditors and that at any rate the female defendant, grantee, did not have any fraudulent intent. He affirmed that there was ample evidence to support the trial judge's findings and dismissed the appeal.

63 I cannot find on a balance of probabilities that the transfer was made *bona fide* and for valuable consideration. Consequently the question arises, how much does the plaintiff require to prove before the burden of adducing evidence shifts?

64 A consideration of some of the principles involved in a conveyance for valuable consideration in the context of fraud is indicated.

65 In *Harman v. Richards* (1852), 10 Hare 81 at 89, 68 E.R. 847, Turner L. J. states:

> Those who undertake to impeach for *malâ fides* a deed which has been executed for valuable consideration have, I think, a task of great difficulty to discharge.

66 May on Fraudulent Conveyances at p. 78 says:

> In cases of voluntary gifts it matters not whether or not the volunteers had notice of the fraud, but where there has been a conveyance for value, not only must fraud be shewn but in order to avoid the transaction as against the purchaser it must be shewn that *he was privy to the fraud against creditors*. Unless this position can be established, the purchaser who has paid his money or other consideration has a right paramount to that of creditors.

> When a deed is made for value, the question is, whether it was made bona fide; .... The fact that there is valuable consideration shews at once that there may be purposes in the transaction other than the defeating or delaying of creditors, and renders the case, therefore of those who contest the deed more difficult. ... A fraudulent intention, to which the purchaser was a party, will over-ride all inquiry into the consideration.

> It is a question of actual and express fraud, and, as actual fraud is always a question of fact more than of law, it is impossible to lay down any definite and exact rules as to what is or what is not fraud ... there are certain circumstances which have always been looked upon as 'badges' of fraud, that is, their presence will, unless satisfactorily explained, be evidence of bad faith, while, on the other hand, their absence will not necessarily rebut the existence of fraud.

(The italics are mine.).

67 W. R. D. Parker's text, Frauds on Creditors and Assignments for the Benefit of Creditors, Toronto, 1903, relies on the case of *Beavis v. Maguire* (1882), 7 O.A.R. 704, for the following statement:

> When the transaction is voluntary the fact that creditors are defeated gives rise to a presumption of fraudulent intent, but where there has been a valuable consideration the presumption does not arise. The intent has to be deduced as a fact from the whole evidence, not necessarily without aid from the fact, if it so appears, that creditors have been delayed, or defeated, but without the more or less conclusive effect which the authorities have attached to that fact in the case of voluntary settlements.

68 A valuable outline of the considerations relating to conveyances for valuable consideration is found in the case of *Bank of Montreal v. Vandine*, 33 M.P.R. 368, [1953] 1 D.L.R. 456. The facts in that case were the following:

69 The plaintiff was a creditor of the defendant Vandine. The Bank alleged that Vandine sold his real estate to one Taylor for $15,000 in order to defeat his creditors since the land could have realized at least $25,000. It had been argued that this was a fraudulent preference, but the trial judge correctly pointed out that since there was no debtor-creditor relationship, that contention must fail.

70 At the trial of the action, Harrison J. found as a fact that Vandine was not insolvent at the time of the transfer to Taylor. He continues at p. 460:

> Two questions have to be determined under the *Statute of Elizabeth* — (1) Whether the conveyance in question was made by the debtor with the intent 'to delay, hinder or defraud' his creditors; and — (2) If there was such intent, whether the party buying such property participated in such fraudulent intent. The burden of proof as to fraud by the debtor in making the conveyances is upon the party seeking to set aside such conveyances where, as in this case, the conveyances in question were made for valuable consideration. ...
>
> In considering the evidence as to whether the conveyances in question were made with a fraudulent intent, while the decision is upon a matter of fact, there are certain features of such transactions which have been considered to be badges of fraud:
>
> (1) Secrecy. ...
>
> (2) Generality of Conveyance. ...
>
> (3) Continuance in possession by debtor. ...
>
> (4) Some benefit retained under the settlement to the settlor.
>
> Parker lists among minor badges of fraud — Gross excess of value of property over price paid. ... Another minor badge of fraud is where cash is taken in payment instead of a cheque. ...
>
> Regarding the burden of proof under the *Statute of Elizabeth*, Kerr on Fraud and Mistake, 6th ed., states at p. 265:
>
> 'In cases of voluntary gifts, it matters not whether or not the volunteers had notice of the fraud; but where there has been a conveyance for value, not only must fraud be shown, but, in order to avoid the transaction as against the purchaser, it must be shown that he was privy to the fraud against creditors. ...'.

71 The learned trial judge found that in the circumstances of this case no fraud had been proved against Taylor, that he had no fraudulent intent, and that he had paid valuable consideration for the property in question. The Court of Appeal upheld the trial judge's decision, and approved of his reasoning.

72 Another valuable general outline is found in the judgment of LeBel J. in the case of *Ferguson v. Lastewka*, [1946] O.R. 577, [1946] 4 D.L.R. 531. In that case the plaintiff is judgment creditor of A. An accident on 3rd April 1944 resulted in death of plaintiff's husband and serious injury to herself. On 3rd July 1944 defendant conveyed the farm to his son-in-law for valuable consideration. Plaintiff instituted an action in regard to the accident on 21st November 1944. LeBel J. at p. 580 stated:

> As a result, I find that the impeached conveyance was given for valuable and adequate consideration, and I conclude, as counsel for the plaintiff conceded at the close of his argument, that to succeed the plaintiff must establish an actual and express intent to defraud creditors on the part of Lastewka and that the Ewaschuks were privy to such intent: see *Hickerson v. Parrington* (1891), 18 O.A.R. 635 at 640-641; May on Fraudulent Conveyances, 3rd ed. 1908, p. 62; and *Cadogan v. Kennett* (1776), 2 Cowp. 432, 98 E.R. 1171.
>
> It is stated by Sir G. J. Turner V.C. in *Harman v. Richards* (1852), 10 Hare 81 at p. 89, 68 E.R. 847, that '... those who undertake to impeach for *mala fides* a deed which has been executed for valuable consideration have, I think, a task of great difficulty to discharge'; but it has been said that a fraudulent intention to which the purchaser is a party will override all inquiry into the consideration: see May, *op. cit.* p. 63, and the cases cited in footnote (*t*); see also *McMullen v. Dr. Barnardo's Homes National Incorporated Assn.* (1924), 26 O.W.N. 168.
>
> The question of intent to defraud creditors is one of fact which the Court has to decide on the merits of each particular case, after taking into account all the circumstances surrounding the making of the conveyance: see *Hawley v. Hand* (1921), 50 O.L.R. 444, 64 D.L.R. 504; 15 Halsbury, 2nd ed. 1934, p. 250; *Ex parte Mercer; In re Wise* (1886), 17 Q.B.D. 290; May *op cit.*, p. 70, and *Hale v. Metro Saloon Omnibus Company* (1859), 28 L.J. Ch. 777, 62 E.R. 189. Mere suspicious circumstances are not sufficient to establish actual fraud: see *Hickerson v. Parrington, supra*, at p. 643, and *Shephard v. Shephard*, 56 O.L.R. 555, [1925] 2 D.L.R. 897.

73 The learned trial judge went on to discuss some of the badges of fraud which he had considered in this case; unusual haste in the transaction, the conviction of Lastewka on an offence with the same accident; the short time Lastewka had owned the property before selling it; the knowledge of a possible civil action by both vendor and vendees, the fact that Lastewka's money from the transaction had all gone to Mrs. Lastewka, the fact that Mr. and Mrs. Lastewka both lived on the farm for several months after it was purportedly sold.

74 As to onus, there is this comment on p. 585:

> Mr. Schreiber also argued that the Court should not consider the relationship between the parties where valuable consideration is proved, and I agree with him, generally speaking, but the case at bar is, in my opinion, very different on the facts from the case of a stranger who buys property with knowledge of other existing and prospective creditors. In the present case it is, in my opinion, permissible to consider the question of relationship in the light of all the other circumstances of the case.

75 *Caulfield, Burns and Gibson Ltd. v. Kitchen and Brooks, supra*. In this case the defendant Brooks sold a business to defendant Kitchen for a $20,000 sale price, the balance of purchase price of $14,000 to be paid in monthly instalments of $150 each with twice yearly interest payments. Kitchen did not make his interest payments in 1954 and 1955, but made his principal payments fairly promptly. At a later date, a chattel mortgage was given by Kitchen to Brooks to assure the payment of the outstanding $12,560. The present action was commenced by certain other creditors of Kitchen. These creditors were trying to set aside the chattel mortgage. LeBel J. at p. 701 (after disposing of the Assignments and Preferences Act) said:

> The argument based upon the *Fraudulent Conveyances Act* can be dealt with very briefly. The plaintiffs do not have to establish insolvency on this branch of the case, but in commercial cases the attack is made, almost universally, from that

> point of vantage. Here there is no ground on which it could be held that this conveyance was 'made with intent to defeat, hinder, delay or defraud creditors or others' within the meaning of section 2 of this statute. Unlike the *Assignments and Preferences Act* it, like the statute, 13 Eliz. c. 5, does not prohibit preferring one creditor to another. ... The question of preferences does not arise under this branch of the case.

76 As to the specific matter of intention, the words of Street J. in *Carr v. Corfield* (1890), 20 O.R. 218 at 221, 3 Can. Abr. (2nd) 2722, are noteworthy:

> The fraudulent intention is a material element in cases of this nature, and where it does not exist the action cannot succeed. The fact that the result of a conveyance is to defeat creditors is not necessarily proof that the intention of the grantor in making it was fraudulent: *Freeman v. Pope* (1870), L.R. 5 Ch. 538; *Ex parte Mercer*; *In re Wise* [*supra*]; *Ex parte Taylor*; *In re Goldsmid* (1886), 18 Q.B.D. 295; and here another and a sufficient motive and reason for the conveyance has been shewn.

77 That reason was that Mrs. Corfield was dealing with some money on the assumption that she was a mere trustee, and she purposed to place in the name of some children land which she bought with what she believed was their money. See also the short statement of LeBel J. in *Caulfield v. Kitchen, supra*.

78 It has also been frequently cautioned that mere suspicion is not sufficient. The leading Canadian authority on this topic is the case of *Shephard v. Shephard, supra*. The facts in that case, as taken from the headnote, are as follows. The defendant T. S., the husband of the plaintiff, was entitled under the will of his father, who died in May 1922, to one-third of his father's estate, which was valued at about $34,000. On the 13th December 1922, the plaintiff commenced an action for alimony; and on the 20th December an arrangement was made between T. S. and his mother and brother, who were each entitled under the will to one-third of the estate, whereby T. S. accepted government bonds of the value of $11,670 as representing his share, and executed a release of all his interest in the estate, whereupon T. S. left the province. The wife claimed to have the release set aside under The Fraudulent Conveyances Act. Middleton J.A. advises at p. 557:

> In many cases where a transaction takes place between near relatives, the result of which is to defeat a claim, it has been said that the onus is shifted to the parties supporting the transaction, and that the transaction should not in general be upheld upon the uncorroborated evidence of the members of the family, and that this is not a finding of fact of an affirmative character merely because negative evidence is suspected or disbelieved. This must not be pushed too far, because when questions of knowledge and intention are under discussion, these generally do not permit of corroboration from outside sources ... I am ... convinced of the adequacy of the consideration paid for the releases given.
>
> The only question is, whether all this was done with the intention of defeating the plaintiff. The learned trial Judge has, I think, rightly adopted the principle of the case of *Hickerson v. Parrington* [*supra*], that where once the Court is convinced of the actuality of the transaction, and that valuable consideration has been given, the plaintiff cannot succeed without actually proving an intention to defraud creditors of the grantor; and this, it appears to me, must be based upon something far beyond mere suspicion. Suspicion will not shift the onus in a case of this kind.

79 The instant transaction being between two companies controlled by the same person I am impelled to consider *Re Fasey; Ex parte Trustees*, [1923] 2 Ch. 1.

80 The increasing sophistication of commercial dealings requires close examination to determine the vital question: Whether or not the conveyance is merely a cloak which a debtor uses to retain some benefit to himself. Although the facts in the case of *Re Fasey*; *Ex parte Trustees*, *supra*, are not too closely related to our problem, I feel that the judgment is interesting for its approach to the thorny questions of individual and corporate activity: In that case the facts are taken from the headnote and are: A builder, in embarrassed circumstances, against whom numerous creditors had obtained judgments, entered into an agreement on 29th July 1921, with an agent on behalf of a company to be formed, whereby he agreed to sell to the company all his property (including his business) with certain exceptions of inconsiderable value, in consideration of £30,000 to be satisfied by the allotment to the vendor or his nominee of 30,000 fully paid one pound shares in the capital of the company,

the appointment of the vendor as governing director at a salary of £2,500 a year, and an undertaking by the company with the vendor to pay and discharge the business debts and liabilities of the vendor and indemnify him against the same. The company having been incorporated and having adopted the agreement, the vendor and his solicitor became the directors and were the only shareholders of the company. It was raised in argument that the onus of proof was on the trustees (plaintiff). P. O. Lawrence J. at p. 9 has this to say:

> Then, it is further contended that no fraudulent intent on the part of the company has been shown and that such intent is essential in order to enable the Court to declare the agreement void under the statute. In my view, that contention is unsound. What is required by the Act to be shown, where there is a conveyance for valuable consideration, is that the purchaser had notice or knowledge of the fraudulent intent. ...
>
> On the facts here, it is quite plain that the company had full knowledge of everything that was being done in this case. As its sole directors and shareholders were the bankrupt and Mr. Timbrell, they were the principals concerned in the fraudulent intent.
>
> In my view this is a barefaced attempt to cheat the creditors of the bankrupt by a conveyance of the bankrupt's property to the bankrupt himself and to his solicitor, and thereby withdrawing from those creditors the only assets which were really worth having. The company itself, in the circumstances of this case, cannot possibly stand in any better position than the bankrupt; it is really but a name which has been changed.

81 On appeal, the trial judgment was upheld.

82 Lord Sterndale M.R. at p. 11 said:

> ... the considerations that apply to a question under the statute of Elizabeth are very different from those that apply to the question of a fraudulent preference in bankruptcy, because a fraudulent preference constitutes an act of bankruptcy. There is no doubt that the considerations are quite different, although the same circumstances may have to be taken into consideration in each case. ... What we have to see is whether this transaction was for the purpose of disturbing, hindering, delaying or defrauding the creditors of the bankrupt.

83 Speaking of the issuance of shares, he continued at p. 13:

> It seems to me that you could hardly have a more transparent attempt to withdraw the assets from the control and rightful seizure by the creditors, unless it can be said that because the transfer was to a limited company, it cannot be interfered with, ... I do not think you can say [that] ... I do not ignore for the moment ... the fact that a company, although it may be composed of one man only, the transferor himself, in this case of two the transferor and his solicitor, is a separate entity. The bankrupt is not the company and the company is not the bankrupt, but it may very well be that the transaction of the transfer to the company is for the purpose of enabling the bankrupt under the name of the company, really and substantially himself, to get the benefit of the goodwill and assets of the business which he has transferred to the company. What was the position here? ... It is ... true that the creditors would, if bankruptcy had not supervened, have had a right to take the shares of the bankrupt in execution, and possibly if they had exercised that right, they would have been able by means of a winding up, or some other proceedings, to get at the assets of the company, because they would then have been shareholders in the company. If to put them to that way of getting their debts paid was not to hinder them, I do not quite know what hindering is. It seems to me quite clear that the whole object of this transaction was to remove these assets out of reach of the creditors, some of whom had obtained judgments against the bankrupt and were in a position to issue execution, in order that the benefit of the assets might be kept for the bankrupt himself, although under the name of a company.

84 Warrington L.J., at p. 15 said:

> Giffard L.J. in *Alton v. Harrison* (1869), L.R. 4 Ch. 622 at 626 says: 'If the deed is bona fide — that is, if it is not a mere cloak for retaining a benefit to the grantor — it is a good deed under the statute of Elizabeth.' In my opinion this deed was a mere cloak for retaining a benefit to the grantor, the debtor.

85 Atkin L.J. at p. 17 said:

> I have no doubt at all myself that if a debtor, being sorely pressed by creditors, does in fact assign the whole of his property to a company of which he becomes the sole shareholder and all the shares are issued to him, an almost inevitable inference would arise that he did that with intent to delay and hinder his creditors. I think that in fact they would be hindered and delayed.

86 The usefulness to the facts of the present case is derived from the fact that in the case at bar undoubtedly if the $97,000 worth of securities were presently an asset of Dougmor, no one would have cause to complain. The creditors could merely attach those moneys in Dougmor's hands. The cases even hold that if, through laches, Dougmor is allowed to dissipate the funds, the creditors cannot obtain relief. The case is also important in that it does not allow the jargon of the independent existence of com panies to becloud the main issue — the retention by the debtor of a benefit in fraud of his creditors.

87 In the case of *Montgomery v. Corbit* (1896), 24 O.A.R. 311 at 315, Armour C.J.C.P. warns the courts to be careful in scrutinizing cases where valuable consideration is alleged:

> In most cases where a conveyance has been made with intent to defeat creditors, some pre-existing contract or part consideration is set up in support of the good faith of the conveyance, and in all such cases it is the duty of the Court to scrutinize the evidence of such pre-existing contract or part consideration with jealous suspicion, and the present is such a case.

88 In the affidavit of Morris, para. 6, there is an allusion to a pre-existing contract but no explanation was given for my scrutiny.

89 There remains to consider three questions:

90 (a) Was the sale *bona fide?*

91 (b) Were the creditors defeated?

92 (c) Did the purchaser participate in the fraudulent intent?

93 The last question must be answered in the affirmative. Firstly, Morris is the president of both corporations and the other directors are also common to both companies. Surely the knowledge of Morris as president of Dougmor is also the knowledge of Morris as president of Wilgorn, and I must impute knowledge and concurrence of the grantee in these circumstances. Indeed the ties between the corporations could not be closer. Dougmor and Wilgorn are in fact controlled by the same group and are what is generally known as related corporations. Having in mind the relationship between the two companies and the various suspicious circumstances and the fact that the transaction was not a voluntary one, in my opinion the burden of producing evidence has shifted and I so find. Section 3 of The Fraudulent Conveyances Act excepts transactions where there has been good consideration and where the transfer was made *bona fide*. In my view the phrase *"bona fide"* in this context ought to be taken to mean a sale to a *real* purchaser and not merely a *nominee* or put another way, the transaction must be more than a *form* of purchase. The phrase *"bona fide"* signifies something done in good faith without fraud or deceit or collusion. There must be honesty in fact. There must be *complete frankness*. In considering s. 3 of the Act, I am again faced with the question of onus or proof thereunder. While the overall onus in this case rests on the plaintiff to the end, nevertheless there is a duty to testify or adduce evidence and to present to the court for its scrutiny all the information as to consideration within the knowledge of the purchaser. The burden of proof in any proceeding lies at first on the party against whom the judgment of the court would be given if no evidence at all were produced on the other side. In other words, the burden of proof as to any particular fact lies on the person who wishes the court to believe in the existence of that fact.

94 To entitle Wilgorn to the benefit of s. 3 of The Fraudulent Conveyances Act, Wilgorn surely must adduce evidence of the actual payment of the moneys independently of the recitals in the deed and the land transfer tax affidavit. The burden or duty of producing evidence to satisfy the court does have the characteristic which is referred to as "shifting". At the risk of being redundant I repeat that the burden to prove his case is always on the plaintiff whether the defendant introduces evidence

or not, but in a situation where the question of fraud is paramount I find that there was a duty to *adduce* evidence and this Wilgorn and Dougmor did not do.

95 In *Koop v. Smith*, already discussed, *supra*, Duff J. said:

> I think the true rule is that suspicious circumstances coupled with relationship make a case of *res ipsa loquitur* which the tribunal of fact may and will generally treat as a sufficient *prima facie* case, ...

96 As held in that case the suspicious circumstances coupled with close relationship (in this case between Dougmor and Wilgorn) makes a sufficient *prima facie* case.

97 If $97,000 worth of securities were in fact transferred there must have been better evidence thereof than contained in the land transfer tax affidavit. If as set out in para. 6 of the affidavit of Morris referred to above Wilgorn was the beneficial owner of the lands, there must have been better evidence available for me to scrutinize.

98 I find therefore that having in mind those considerations which would apply if this were a transfer for valuable consideration:

(a) that the transaction hindered the creditors of Dougmor;

(b) that this was not a *bona fide* transaction;

(c) that Wilgorn had full knowledge of the transaction and consequently participated in the fraudulent intent.

99 It must not be taken from what I have just found that proof of valuable consideration is sufficient *per se*. I do not in fact find that there was present in this transaction such "valuable consideration" as is envisaged by the statute.

100 In the result, I find the said conveyance to be fraudulent.

101 The plaintiff shall have his costs of this action to be taxed.

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TAB 11

1967 CarswellOnt 56
Ontario Court of Appeal

Dougmor Realty Investments Holdings Ltd., Re

1967 CarswellOnt 56, [1968] 1 O.R. 61, 11 C.B.R. (N.S.) 153, 65 D.L.R. (2d) 419

Re Dougmor Realty Holdings Limited; Fisher v. Wilgorn Investments Limited

McGillivray, Evans and Laskin JJ.A.

Judgment: October 11, 1967

Counsel: *F. S. Weatherston, Q.C.*, for appellant.
M. B. Page, for respondent.

Subject: Corporate and Commercial; Insolvency; Civil Practice and Procedure
Related Abridgment Classifications
Bankruptcy and insolvency
XI Avoidance of transactions prior to bankruptcy
XI.2 Fraudulent preferences
XI.2.b What constituting preference
XI.2.b.ii Whether transaction occurring in debtor-creditor relationship
Civil practice and procedure
XX Trials
XX.7 New trial
XX.7.a Grounds for granting
XX.7.a.vi Miscellaneous
Debtors and creditors
XII Fraudulent conveyances
XII.11 Practice and procedure
XII.11.f Burden of proof
XII.11.f.i General principles
Headnote
Practice --- Trials — New trial — Grounds for granting — General
Fraudulent conveyances — Conveyance of land from bankrupt company to associated company within three months of bankruptcy — Necessity that "creditor" receive a preference — Burden of proof — Conveyance declared fraudulent as against trustee — The Bankruptcy Act, R.S.C. 1952, c. 14, s. 64 — The Fraudulent Conveyances Act, R.S.O. 1960, c. 154, ss. 2, 3, 4.
Appeal from 10 C.B.R. (N.S.) 141, where the facts are set out.
Held, the appeal should be allowed and the matter referred for a retrial of the issue previously directed.
The trial had been unsatisfactory in that the case had originally been confined, and all evidence had been directed to a consideration of, the provisions of s. 64 of the Bankruptcy Act and not of The Fraudulent Conveyances Act. Accordingly, all matters at issue in the case, including both the question of fraudulent preference and that of fraudulent conveyance, should be re-opened.

Appeal from [1967] 1 O.R. 66, 10 C.B.R. (N.S.) 141, 59 D.L.R. (2d) 432.

The judgment of the Court was delivered by *McGillivray J.A.* (orally):

1 This is an appeal by Wilgorn Investments Limited from the judgment of Lieff J. pronounced on 13th October 1966 after trial of an issue directed by order of McDermott J. dated 11th January 1966. The issue directed was as to

> whether there has been a fraudulent conveyance from Dougmor Realty Holdings Limited to Wilgorn Investments Limited, which conveyance is dated the 31st day of May, 1965, and registered in the Registry Office for the Registry Division of the County of Halton, for Burlington ... on the 3rd. day of June, 1965.

2 Notwithstanding the terms of the issue directed, counsel for the plaintiff at the opening of the trial confined his case to the question of whether the conveyance fell within the provisions of s. 64 of the Bankruptcy Act and all of the evidence was directed to consideration of that matter. At the close of the plaintiff's case counsel for the defendant called no evidence. Judgment was reserved at this time after argument had been heard. Subsequently the learned trial Judge, by letter, invited counsel to address further argument on the question whether the transaction was fraudulent other than by s. 64 and particularly if it were so under The Fraudulent Conveyance Act. Counsel attended before the trial Judge pursuant to this request but no record of what occurred at that time is available. Apparently argument was heard as requested and counsel for the appellant states that he did register an objection to the case proceeding on any other basis than that which the Court had heard in the course of the trial.

3 The learned trial Judge in his reasons subsequently delivered made a finding that no debtor-creditor relationship existed between the parties and, as a consequence, that no fraudulent preference had been established. He further found, however, that there had been a fraudulent conveyance and he cited a number of reasons which he felt justified this conclusion. In the course of these reasons he stated that he was influenced by the fact that the defendant had called no evidence in the case.

4 On appeal to this Court counsel for the appellant submits that the issue decided by the trial Judge was one on which his client had been given no opportunity to be heard as no opportunity to call evidence was given and that counsel had not been able to cross-examine on the point in question as it was specifically understood from the start of the trial that the matter in issue was whether or not there was a fraudulent preference under the Bankruptcy Act.

5 The Court is prepared to give effect to these submissions notwithstanding the fact that the matter directed by McDermott J. to be considered was whether or not there had been a fraudulent conveyance for the trial of the issue appears to have been unsatisfactory in the manner which has been stated.

6 At the hearing before this Court counsel for the respondent took issue with the finding of the trial Judge that no debtor-creditor relationship existed and asked that the judgment be sustained upon the ground that such relationship did exist. The respondent did not, however, serve a notice to vary as provided by R. 503 of the Rules of Practice of the Supreme Court of Ontario. Even though the Court under that rule might still consider this matter, counsel for the appellant has not come prepared to present argument upon a question of which he has had no notice. In short, the trial having been unsatisfactory it is the opinion of members of the Court that the appeal should be allowed and that the matter should be again referred for a retrial of the issue previously directed. The Court is further of the opinion that the appeal should be allowed without costs. It bases this decision upon the fact that, notwithstanding the manner in which the case was presented to the trial Judge, the actual reference was in wider terms and counsel for the appellant, had he chosen to do so, could have insisted more forceably than he did that he be allowed to meet the issue which was eventually presented.

7 It is the intention of the Court that all matters at issue in this case, including both the question of fraudulent preference and that of fraudulent conveyance, should be reopened.

8 The costs of the first trial are to be in the discretion of the trial Judge.

TAB 12

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PETER SMITH, Respondent, *v.* P. A. MORSE *et al.*, Appellants.

Corporations are bound to follow strictly the letter of their charter, and can exercise no power unless granted to them, or absolutely necessary to carry out the power so granted.

The first charter of the city of San Francisco does not authorise the creation of a sinking fund commission *in terms;* nor is there any clause under which it can be exercised even by implication.

The power to sell does not include an authority to create a new department of city government, to divert the revenues from their legitimate source, and place them in hands neither chosen by, or responsible to, the corporators.

The common council must exercise the functions imposed by their charter, and have no power to delegate them to others.

The power to sell does not include the power to make a deed of trust, with power to the trustees to sell the trust estate as they may *deem advisable.*

A conveyance that would come within the Statute of Frauds if made by an individual, if made by a corporation would be liable to the same construction, and if void in the former case, would be void in the latter.

Such conveyance will not affect the lien of a judgment regularly obtained against the grantor.

A deed, void by reason of fraud, cannot be made valid by an act of the Legislature, so as to affect the rights of third persons.

Qu. If the intention of the Legislature by the act of May, 1851, to confirm the void acts of the Common Council, and the deed to the commissioners of the Sinking Fund, can be fairly inferred from the language of the act.

The Legislature may, from time to time, alter or change the remedy, provided they do not materially affect the *right;* but whenever they so far alter the remedy as to impair, destroy, change, or render the right scarcely worth pursuing, they necessarily impair the obligation of the contract upon which such right is founded.

An act which divests the lien of the creditor altogether, which exempts the property of the judgment debtor from execution, places it in the hands of trustees with power to sell as they may think proper, and compels the creditor to fund his scrip at a less rate of interest, and submit to a delay of twenty years, without any guaranty that he will then receive the principal, and that renders the creditors right worthless, by withdrawing his remedy, and such is the act to fund the indebtedness of the city, which therefore impairs the obligation of contracts, and is unconstitutional and void as against the plaintiff.

The act of 15 April, 1851, re-incorporating the city of San Francisco by its provisions, continued the body politic as a corporation, and did not extinguish the debts of the city incurred under the former charter, nor did its property escheat to the State. An act passed with such intention, would be unconstitutional and void.

The city cannot set up a right in the State, to defeat a claim against her. If her right, title and interest in property has been sold by the sheriff, and the State has any right, the latter can assert it when she chooses to have it ascertained.

By the Statute of 1850, personal property levied on by the sheriff, must be actually seized and sold in *presence of the purchaser*. While a lien attaches to real estate upon the filing of the transcript, and the same is to be sold *in front of the Court-house door;* and all leasehold estates of more than one year are to be so disposed of.

The clerk of the Court has power to issue a *venditioni exponas* at common law, or under the statute "to regulate proceedings in the District Courts," of 1850, p. 24, which authorises the Court to frame new writs and process, and to issue such executions and other writs as may be necessary to carry their judgments into full force and effect."

The act of the city of San Francisco creating the board of Sinking Fund Commissioners, and the deed executed to them of all the property of the city, is void for want of power in the city, and because said deed is within the Statute of Frauds.

The act of May 1st, 1851, funding the debt of the city, is unconstitutional, so far as the rights of the plaintiff are affected thereby; and the levy and sale are regular and valid.

APPEAL from the Superior Court of the City of San Francisco.

The statement of facts in this case sets forth the Act of 15th April, 1850, incorporating the City of San Francisco, art. 1, and 2d section of which gives the city the right to "grant, purchase, hold, and receive property, real and personal, within said city, and to lease, sell, and dispose of the same for the benefit of the city." Section 1st of art. 2d, allows the Mayor and Common Council "to borrow money and pledge the faith of the City therefor, provided the aggregate amount of the debts of the City should never exceed three times the amount of its estimated revenue." Sect. 9, to provide for the erection of public buildings, &c., and all lawful improvements, &c. 21. To provide for the appointment of all necessary officers, &c. 29. To appropriate money for any item of city expenditure, and provide for the payment of her debts, &c. Art. 5, provides that the Legislature may, at any time, alter, amend, or repeal the charter. See Statutes, 1850, 223 et seq.

On the 23rd of August, 1850, an ordinance was passed by the Mayor and Aldermen for the creation of a city stock, to be called a Sinking Fund Stock, for the erection and promotion of city improvements,—limiting the amount to $500,000,—prescribing the periods of its redemption, and pledging "all the city lots, or real estate in possession of the City, as security for the redemption of the said stock and interest at their maturity." Sect. 5, provides for the appointment of five persons who shall constitute a board, to be entitled the Commissioners of the Sinking Fund, to be composed of the Mayor and Comptroller and three citizens, who shall give bonds for faithful performance, &c., to the amount of $100,000 each; who, by sect. 6, were to have charge of all real estate belonging to the City, to lease or sell the same as in their judgment should be deemed advisable, for its benefit, and as shall be required to provide funds for the redemption of the public debt. Sect. 7, directs the mode of disposing of the City property,—that it shall be advertised two weeks, and sold at public auction to the highest bonâ fide bidder.

By the ordinance of 1st October, some of the provisions of the foregoing ordinance were altered; the stock was increased to $800,000, and the security reduced to $100,000 by a joint bond from all the commissioners, and requiring them to report quarterly a statement of receipts and disbursements, &c.

On the 23d December, an ordinance was passed, requiring the presidents of the two boards of aldermen to sign the deed of trust for the conveyance of the city property to the commissioners of the Sinking Fund on behalf of the city.

By deed, dated 25th December, 1850, the city, in consideration that the grantees had accepted the appointment of commissioners of the Sinking Fund, and given bond and security for faithful performance, &c., "did *bargain, sell* and *convey* unto John W. Geary, William Hooper, James King, of Wm., Benjamin L. Barry and Talbot H. Green, of said city, as the Commissioners of the Sinking Fund, &c., and their successors and assigns, all" (a large number of beach and water lots and upland lots, and a number of wharves, &c., particularly described): In trust that the said commissioners shall have charge of all the said lots, &c. as a security for the redemption of the bonds and interest issued under the ordinances, 49 and 67 (above recited:)

And to lease and sell the said lots as in their judgment should be for the benefit of the said city, and shall be requisite to provide funds for the redemption of the said bonds and interest; which deed was duly executed 26 December, 1850, and recorded the 6th January, 1851.

By the ordinance of 20th January, 1851, the Commissioners of the Sinking Fund are authorised to receive city scrip, or audited accounts against the city, in payment of any of the lands and property *conveyed to them,* and which might be sold by them.

On the 15th April, 1851, the legislature passed an act, re-incorporating the city—enacting that the people of the said city shall *continue to be* a body politic and corporate, under the style of the "City of San Francisco," granting the usual powers and the right to purchase, receive and hold property, real and personal, and to sell and dispose of the same for their common benefit—providing for the organization and the election of officers, &c. Section 14 provides that all money received from the sources mentioned in the section, "shall continue to constitute a sinking fund, for the payment of the existing city indebtedness and interest thereon, until the same shall be cancelled. The sources named, include "the net proceeds of all sales of real estate, bonds and mortgages, for occupation of wharves, basins and piers, wharf-rents and tolls, and prohibits the loaning of the fund, or its application to any other purpose.

Art. 4, sect. 1, vests the executive power in the mayor, and *such other executive officers as are, or may be, created by law,* and prohibits the common council, any committee or member thereof, from performing any executive or ministerial business, unless *specially directed by law.*

Section 20, provides that the officers of the present city government "shall continue in office *under this charter, with such powers and duties as are herein prescribed,* until their successors are qualified, and *nothing herein contained shall be construed to release any persons heretofore holding office in said city* from any personal liability which they may have incurred by their official acts. And article 6, section 12, repeals the act entitled an Act to incorporate the City of San Francisco, passed April 15th, 1850.

Before the passing of the above act, an act was passed April 1st, 1851, which enacted, that the city should not have power to either sell, lease, or in any manner convey, any lands situated within the corporate limits, from the passage of this act until the 10th of May next, or thereafter. And prohibited any officer, commissioner or agent of the said city, from making any disposition of such lands contrary to the said act, and declaring any such sale, &c., void.

By act of 1st of May, 1851, the legislature authorised the funding of the floating debt of the city, and the providing for the payment of the same. And P. A. Morse, D. J. Tallant, William Hooper, John W. Geary, and James King, of Wm., were appointed and *constituted commissioners of the funded debt*. And this act directs their organization as a board. Section 2 authorises the commissioners to issue certificates of stock to an amount equal to the aggregate of the floating debt at the time of passing the act, bearing ten per cent. interest. And section 3 authorises them to exchange such certificates with creditors, in extinguishment of an equal amount of the floating debt.

Sect. 4, directs the Commissioners to certify to the City assessor the amount necessary to be raised for payment of the interest of the funded debt for the current year, and that the assessors add such amount to the amount authorised to be raised for other purposes, and also the further sum of $50,000 yearly for a sinking fund for the redemption of the said stock; and directs the payment thereof by the Treasurer to the Commissioners, before any payments are made for other purposes.

Sect. 5, directs the Commissioners, out of the money so raised and paid them, to pay the interest of the stock when due, and apply the balance to payment of the principal, &c., and to render an account yearly to the Councils.

Sect. 6, provides for the redemption of the stock, and after the execution of the trust for its surrender, and for the reconveyance of the remaining property &c., to the City.

Section 8, authorises persons "holding indebtedness of any character against the city," to exchange the same for said certificates, as provided in section 2.

Section 9, requires creditors, to entitle them to the benefits of this act, to signify their election within ninety days after its passage, or after the settlement and approval of their claims.

Section 11, exempts forever from sale by execution, "all property of the City of San Francisco, which is necessary to be retained for all or any of the municipal purposes of the city."

By section 12, the commissioners of the sinking fund, created by the ordinance of councils, are required to convey to the said commissioners of the funded debt, all the property, and all their right, title and interest in property belonging to the city, and to pay over all funds in their hands, &c. And said commissioners are authorised to expose to public sale, or to lease the property, so to be conveyed, at such times and places as the interests of the city may require, and apply the proceeds to the liquidation of the floating debt of the city.

Section 14, directs surplus funds in the hands of the commissioners, to be applied to the extinguishment of stock, and the method.

By deed, dated 24th May, 1851, (acknowledged 31st of same month,) Geary, Barney, Talbot, Green, Hooper, and King, commissioners of the sinking fund, did grant, bargain, sell and convey unto Morse, Talbot, Hooper, Geary, and King, the commissioners of the funded debt, all the lots, wharves, &c., described in the deed of December 25th, 1850, except such as had been sold by the commissioners of the sinking fund; to hold the same in trust, to have charge of the same, and with power to sell or lease the said lots, &c., as in their judgment may be for the benefit of the said city, and to apply the proceeds according to the provisions of the said act of May 1st, 1851.

On the 25th January, 1851, Peter Smith (the plaintiff) recovered judgment in the Superior Court of San Francisco against the city, for $19,239, with interest at 3 per cent. per month, from January 8th, 1851; which judgment was signed March 4th, 1851.

On the 4th of March, 1851, Smith recovered another judgment (signed the 10th of the same month,) in the same Court, against the city, for $45,538.32, with interest at 3 per cent. per month, from the date.

On the 8th of March, the clerk of said Court issued execution on the judgment of 25th of February, commanding the sheriff to satisfy the same out of the personal property, and if sufficient could not be found, then out of the real property belonging to the said city, at or after the date of the judgment, and to make return within forty-one days. The sheriff returned that he had levied on the City Hall, the Hospital, and the Prison Brig, and several wharves, but that the sale was stayed by injunction.

On the 10th of March, 1851, the clerk issued a similar execution on the judgment of 4th of March, to which the sheriff returned, on the 3rd of April, 1851, that he had levied on all the lots conveyed to the commissioners of the sinking fund, by the deed of 25th of December, as per schedule annexed, but that the sale was stayed by injunction.

On the 22nd of May, the clerk issued a writ, reciting the execution of March 8th, and commanding the sheriff "to cause to be sold the property so levied on," for the best price, &c., and to make return, &c. On the 20th of August, the sheriff returned that he had sold the City Hall, the Hospital, and the wharves, for $8050.

On the 27th of May, execution issued on the judgment of February 25th, for the balance, $1369.88, due thereon. On the 19th of September, the sheriff returned, that he had sold to divers persons several lots, specifying them, for an aggregate of $5,494.50, and had otherwise made on the execution $1254, making together, $6,749.36.

On the 8th of December, 1851, another execution issued on the same judgment, for a balance of $8,194.10. On the 12th of January, 1852, the sheriff returned, that he had levied on a large amount of water property, as described, and by order of Court sold the same on the 2nd of January, 1852, to McDougal, Bell, and Malony—nine of the tracts levied on, for $19,800—(describing them,) and further returned the execution, satisfied.

On the 22nd of May, 1851, the clerk issued a writ, reciting the execution of March 4th, and the levy and return of the sheriff, (particularly describing the property,) and commanding the sheriff to "cause to be sold the property so levied on, for the best price that can be got for the same, and have the money," &c. On the 20th of August the sheriff returned this writ, that by virtue of the same, he had levied upon all the right, title and interest of defendants, in and to the following described property, and after giving due notice, according to law, sold the said property as per schedule annexed, for $47971.50; among the lots sold, No's. 509, 135, and 139, were bid off by Smith, for $1080, and which were described in the writ; the sale was made the 14th of June, 1851, but some of the purchasers failing to pay their bids, a re-sale of such lots was made on the 25th of the same month.

By deed, dated June 14th, 1851, (acknowledged 18th of July,) reciting the judgment of 4th of March, and that it was recorded on the 14th of March, 1851; the issuing of the execution of the 10th of March, and the levy thereon, and the return; the writ of May 22nd, 1851, commanding the sheriff, that he "*should cause to be sold the property so levied* on," &c.; *the advertisement of said property, in pursuance of the said last mentioned writ,* to be sold in front of the court house, &c.; that at the time and place advertised, he offered the same for sale, and that Smith become the purchaser of thirty lots, among which, were lots 509, 135, and 139, for $13,465, &c.; the sheriff therefore granted, &c., to Smith, *in fee,* all the estate, right, title, &c., which the city had, at and after the recording of the judgment, in the said thirty lots.

On the 8th of December, 1851, an execution was issued on the judgment of the 4th of March, for a balance of $8,272; on the 12th of January, 1852, the sheriff made return on this writ, similar to his return on the writ of the same date, issued on the judgment of the 25th of February, stating the sale to McDougal, Becket and Malony, in the same manner, but without any reference to the other writ, and returned the execution "satisfied."

On the 1st of July, Smith filed his complaint in the Superior Court, against Morse and others, who claim to have been appointed commissioners of the funded debt of the city, but whose authority he denied, &c. It stated the judgments of the 25th of February and 4th of March, and the writs of the 2nd of May, and proceedings and sale thereon; that plaintiff's judgments were a lien upon all the property claimed by defendants; that, owing to the interference, claims, and representations of the defendants, as to the title of the property, plaintiff had been unable to realize his judgments, as many persons were deterred from buying, &c.; that defendants wrongfully claimed to be entitled to the property, and had subdivided it into upwards of 3000 lots, and advertised them for sale on the next day; the consequence of which would be to interest numerous persons in the property, and disturb and cloud his title, &c.; that the plaintiff had been damaged by the wrongful acts of the defendants to the amount of $25,000, and would be irreparably injured, unless defendants were restrained from selling the property. Prayer that defendants be enjoined from selling, and for judgment against them, for $25,000 damages; that the injunction be made perpetual, and for general relief.

An order was made, restraining the defendants as asked till the further order of the Court.

The defendants filed a demurrer, which was afterwards withdrawn, and at the same time answered, relying on the deed of December 25th, 1850, the Act of May 1st, 1851, the deed of May 24th, 1851, and the City ordinances; and denied, that the property was liable to the plaintiff's judgments or executions.

On the 19th July, plaintiffs filed an amended complaint, charging that the deed of December, 1850, and the ordinances creating a Sinking Fund, were unauthorized by law and void; that the deed was intended by the Board of Aldermen to place the property of the City beyond the reach of its creditors, and was fraudulent; and that the Act of May 1st, 1851, was unconstitutional, so far as it affected the liens of the plaintiff's judgments. It then averred, that at the sale of June 14th, 1851, plaintiff purchased Beach and Water lots, No. 509, and upland lots, Nos. 135 and 139, and received a deed therefor, which the defendants would have sold but for the injunction. Prayer as in the original complaint.

The defendants answered, denying the alleged fraud and insisting on the validity of the deeds, &c.

A motion to dissolve the injunction was overruled.

On the 17th September, the case was referred by consent to John H. Saunders, Esq. to hear and determine the issues of fact, and of law, and report to the Court.

The evidence adduced before the referee, consisted of the judgments; the dates they were recorded; the several executions and returns of the sheriff; the deed from the sheriff to the plaintiffs; the trust deeds as above stated; the admissions of defendants, that the property described in the complaint, was the property of the City at the date of the deed of December, 1850; that at the said date the debt of the City exceeded three times its annual revenue; that no stock was ever purchased under the ordinances, Nos. 49 and 67; that neither the City nor the Commissioners of the Sinking Fund "received any consideration to create a use" under the said ordinances; that at the time of the execution of the deed of December, 1850, the City was without money, and could not borrow to pay her debts; that John W. Geary was President of the Commissioners of the Funded Debt.

A proclamation of the Commissioners of the Funded Debt, dated 13th June, 1851, warning all persons not to purchase at the sale under Smith's executions; and the admission, that Gallagher and Vanfelker would swear that the said proclamation was the cause of their not taking deeds for property purchased by them at the sale on Smith's executions.

A printed catalogue of lots included in the trust deeds, advertised to be sold by the Commissioners of the Funded Debt on the 2d July, 1851.

The Act of May, 1851.

Proof that Geary warned persons present not to bid, and that some of the purchasers refused to pay their bids on account of representations made by the Commissioners. That in consequence of these representations, the lots sold at a great sacrifice, and would have brought five times what they sold for but for the doubt as to the title.

That Smith could not borrow money on the security of the lots purchased by him; and had to pay a high rate of interest, &c., ten per cent. per month.

Geary testified that no money was borrowed, and no bonds issued by the Commissioners of the Sinking Fund. When the deed of December, 1850, was executed, the City debt was about $1,000,000. A sale of $55,000 made in June, 1852, was consumed pretty much in expenses. The Commissioners endeavoured to obtain a loan, but failed; the City property was worth $350,000 cash, exclusive of the government reserves, &c.; the annual revenue was from three to four hundred thousand dollars; the Commissioners of the Funded Debt have issued bonds to the amount of $1,280,000. The Commissioners organized May 15, 1851.

On the 13th October, 1851, the Referee filed his report, refusing damages to the plaintiff, and stating that in his opinion he had no cause of action, and recommending that the injunction be dissolved.

On the 20th of October, 1851, Smith moved to set aside the report of the referee; and on the 24th November, the Court set it aside, and granted a new trial.

On the 8th January, 1852. Smith filed his supplementary and amended complaint, charging that when the deed of December 25th, 1850, was made, the City was indebted more than three times the amount of its annual revenue, and destitute of funds, and without power to borrow money; that the sums for which plaintiff recovered the said judgments, were then owing and due to him by the City; that the said deed and the deed of May 24, 1851, were made with the intent to defraud creditors; that the Act of May 1, 1851, was procured to be passed by defendants in pursuance of the same fraudulent intent; and that the said act was unconstitutional and void. That on the 6th September, 1851, the plaintiff recovered another judgment against the City for $13,960, with interest; that plaintiff was lawfully seized, &c. of said lots, Nos. 509, 135 and 139; that the pretended title of defendants was a cloud thereon, &c.

Prayer in addition to the relief before prayed; that the deed of May 24th, 1851, be set aside, and the said ordinances and act of the Legislature, and all acts, &c., in pursuance thereof, be declared void, and for general relief.

Defendants answered, denying all the allegations of fraud and insisting on the validity of the deed, ordinances and statute.

In June, 1852, a jury was waived by the parties, and the cause tried by the Court.

The clerk proved the testimony and admissions before the referee; and the following testimony was adduced. An admission, that the act of 1st May, 1851, was procured to be passed on the application of the City and the Commissioners of the Sinking Fund, and the bill prepared at their instance; and while it was pending before the Legislature, the Commissioners sued out an injunction, restraining Smith from selling the property conveyed to him under his executions.

An admission that lot, No. 509, was a Beach water lot, and included in the act of March 26th, 1851, to provide for the disposition of certain property of the State of California. An admission that lots, Nos. 509, 135 and 139, were sold by the sheriff in front of the Court House, and *not in view of the premises.*

The Acts of March 26th, 1851, (Water Lot Act,) April 15th, 1850, (to incorporate the City,) and April 15th, 1851, (to reincorporate the City.)

A map of the City, and an admission, that there was *de facto* an Ayuntamiento, and town or public organization of San Francisco at and before the year 1846; and which continued till the act incorporating the City, and that the map produced was prepared by said *pueblo*, and subsequently enlarged by the City, and is the one referred to in the deeds and statutes given in evidence. Also that prior to the deed of December, 1850, the City had claimed to own the lands described in the deed, and offered them for sale in lots as represented on the map.

The clerk of the Commissioners proved, that they had funded debts, and issued certificates to the amount of $1,549,600 to upwards of 400 persons; and that all the debts had not been funded.

The finding of the Superior Court as to the facts and law, and the judgment thereon, are set out at length in the opinion of the Supreme Court to which we refer.

A motion for a new trial was made by defendants' counsel and overruled. And defendants appealed, 1st, from the order setting aside the report of the referee; 2d, from the order refusing defendants a new trial; 3d, from the final judgment and decree.

The points made by the respective counsel in the argument, are specially stated and considered in the opinion of the Court, and it is therefore deemed unnecessary to repeat them here.

Lockwood, for appellant.
———, for respondent.

The opinion of the Court was delivered by Chief Justice MURRAY, with which ANDERSON, Justice, concurred.

This cause was tried by the Court below, setting as a jury, and the following verdict returned, viz.

"1st. The plaintiff recovered judgments against the city of San Francisco, as alleged in the complaint, supplemental and amended complaint, to wit:—The first, on the 25th day of February, 1851, in the sum of $19,592 with interest at the rate of three per cent. per month, and costs; the second, on the 4th day of March, 1851, in the sum of $45,548 82 with interest at the rate of three per cent. per month, and costs; the third, on the 6th day of September, 1851, in the sum of $13,900 with interest at the rate of three per cent. per month, and costs.

"2d. Transcripts of the first and second of these judgments were recorded and filed in the office of the recorder of deeds of the county of San Francisco, on the 14th of March, 1851; the third was duly docketed on the 6th day of September, 1851.

"3d. The demands upon which these several judgments were recovered, were subsisting liabilities on the 26th day of December, 1850, and a part of the judgment aforesaid, rendered on the 6th day of September, 1851, remains unsatisfied.

"4th. On the 26th day of December, 1850, the aggregate liabilities and indebtedness of the city of San Francisco, was over one million of dollars, and more than thrice as great as the estimated or actual amount of the revenues of said city; the city was then destitute of funds, and was unable to borrow money to pay its debts.

"5th. On the 14th day of June, 1851, the plaintiff became a *bona fide* purchaser under execution, at sheriff's sale, of the beach and water lot No. 509, and of the two upland lots Nos. 135 and 139, as mentioned in said complaints, and on the 18th day of July, 1851, he received from the sheriff a deed of conveyance for said lots, and became the owner of all the right, title and interest which the city of San Francisco had, in those lots, unencumbered and unaffected by the deed of conveyance or assignment, purporting to have been made by the city of San Francisco to the Commissioners of the Sinking Fund, on the 26th day of December, 1850, and unencumbered and unaffected by the deed of conveyance made by said Commissioners of the Sinking Fund on the 24th day of May, 1851, to the defendants, and unaffected by the act entitled "An act to authorize the funding of the floating debt of the city of San Francisco," &c., passed May 1st, 1851.

"6th. The deed of conveyance or assignment purporting to have been made by the city of San Francisco to the Commissioners of the Sinking Fund on the 26th day of December, 1850, and the deed of conveyance made by the Commissioners of the Sinking Fund on the 24th day of May, 1851, to the defendants mentioned in the pleadings, were made with intent to delay, hinder and defraud creditors.

"The Court being of opinion, upon the facts and the law, that the deeds last aforesaid, under which the defendants claim title to the property therein described, are null and void, as against the plaintiff, and are a cloud upon his title to the lots of land aforesaid, which ought to be removed; that they tend to depreciate the value and enjoyment of his property in said lots of land, and to embarrass him in enforcing execution of his judgment yet unsatisfied; and that they ought to be set aside, and declared to be of no force and effect; it was therefore considered by the Court, that the plaintiff do have judgment accordingly. Whereupon it was ordered, adjudged, and decreed, that the deed aforesaid, made by the city of San Francisco, as aforesaid, to the Commissioners of the Sinking Fund on the 26th day of December, 1850, and the deed aforesaid, made by the 'Commissioners of the Sinking Fund' to the defendants, be and the same are hereby set aside, and declared to be null and void. It is further ordered, adjudged and decreed, that the injunction hereinbefore granted against the defendants, be and the same is hereby made perpetual; and it is further ordered and adjudged, that the plaintiff recover his costs, &c., &c."

I shall pass over the objection raised upon the record, that the Court below erred in setting aside the report of the referee, as I conceive the filing of the supplemental bill and answer, by the defendants, cures that defect; and also, because the counsel have desired a decision upon the main questions involved in this case.

I shall take it as true, for it is alleged in the bill, and not denied in the answer, that the indebtedness to the plaintiff, on which judgments were recovered, was a subsisting liability on the 26th day of December, 1850.

On the same day, by virtue of an ordinance of the common council of San Francisco, all the real estate of San Francisco was transferred to the "Commissioners of the Sinking Fund," created by authority of the common council, and by them conveyed, on the 24th day of May, 1851, to the "Commissioners of the Funded Debt."

It is contended by the counsel for the appellant, that the 6th finding of the Court, viz.: "That these conveyances were made with the intent to hinder, delay, and defraud creditors," is erroneous; 1st. Because the City of San Francisco had power, under her charter, to sell and dispose of the property in question, and to create the sinking fund commission.

2nd. A corporation cannot commit a fraud, or do an act with a fraudulent intent.

3rd. The question of fraudulent intent, is a question of fact for the consideration of the jury; and the facts in this case do not support the finding of the Court; and 4th. That, admitting the deed to the commissioners of the sinking fund, was void, for fraud, or want of power on the part of the common council, to create such commission or *department*—still the whole is cured by the act of the legislature, May 1st, 1851, and all the previous acts of the common council, ratified and confirmed in that particular.

The duties and liabilities of corporations have become too well understood, to require this Court to enter into any lengthy discussion of their powers on disabilities; in a word, they are bound to follow strictly the letter of their charter; and can exercise no power, unless granted to them, or absolutely necessary to carry out the power so granted.

The first charter of the City of San Francisco, does not authorise the creation of a sinking fund commission *in terms*, neither is there any clause under which the power can be exercised, even by implication. The power to sell for the benefit of the city, does not include an authority to create a new department of city government, to divert the revenues and property of the city from their legitimate source, and place them in the hands of those, neither chosen by, nor responsible to the corporators of the city.

Again, the common council must exercise the functions imposed upon them by their charter; and have no power to delegate them to others. The power to sell, granted to them, does not include the power to make a deed of trust, or place the property committed to their custody, in charge of others, for the term of three years, with power to sell, as *they* may *deem advisable.*"

I should not have resorted to any argument whatever, to sustain such propositions, were it not for the zeal with which the learned counsel urged this point, and the interests which are involved in an adjudication of the case. The conclusion to which I have arrived upon this point, viz., that the attempt of the common council to create the board of Sinking Fund Commissioners, and to transfer the property of the city, was an unwarranted usurpation of authority, and that the proceedings are void, so far as relates to that transaction, might very well justify me in passing over some of the points raised by the appellant.

But lest I should be mistaken in this proposition, I prefer considering them in their order.

What was the object of the City in creating this commission? the creation and promotion of City improvements? For this purpose, the Commissioners were authorized to issue bonds, to the amount of $800,000 with 2 per cent. interest per month, payable in one, two, and three years; and by the last ordinance, all lots and real estate of the City is set apart and held inviolate, for the payment of these bonds and interest upon them; and the Commissioners are authorized to dispose of said property by lease or sale, as in their judgment shall be most advisable.

To carry out these purposes, a deed was made to them. On the same day the debt of the City exceeded one million of dollars, more than three times its annual estimated revenue, and the plaintiff was at the same time one of its creditors.

Had this been the transaction of a private individual, attempting to place his property beyond the reach of creditors, yet reserving the benefit of it to himself, empowering his assignees to create new liabilities upon his own account, and delaying his honest creditors from making their money, unless the Commissioners thought proper to sell, no lawyer would have attempted to uphold it, in any court of justice. How then does this transaction vary from that of private individuals? The counsel for the appellant contends, "that a corporation cannot commit a fraud, or do an act with a fraudulent intent." "A corporation cannot have the *animus lucrandi* to the fraudulent intent arrived at by our statute," says the learned counsel.

The Statute of Frauds was designed for the protection of the rights of the creditors, and is but an affirmance of the principles of the common law. Corporations are authorized to take and hold property as natural persons, and are to be governed by the laws of the land, in all particulars: no exception is made in favour of them in this respect by our legislature. The fact that no authority can be found to support the proposition, carries with it no conviction: the policy of the statute was to prevent such conveyances; and it would certainly be a new and dangerous doctrine to establish, that municipal corporations might at any time defeat their creditors by a fraudulent assignment, and that the law had given them an immunity in these cases, greater than that allowed to private individuals, when, in truth, their powers are more limited than those of natural persons.

That an individual cannot commit a fraud because he is not to be benefited thereby, is certainly a novel proposition.

The act may be a fraud upon the rights of third persons, and it is not impossible to imagine a case in which the officers of a municipal corporation with or without any interest in the matter, may be guilty of a fraud upon the rights of others. If, however, there be any doubt on this subject, it is true, that doubt should be removed, and all metaphysical refinements, and fine-drawn distinctions of astute logicians, must yield to plain principles of sound morality and justice.

A corporation without soul, will, capacity to do wrong, or legal responsibility, is a legal monstrosity, whose existence no court ought to foster or protect; and common justice requires that the rights of the creditor should be protected from every species of fraud, proceeeding from whatever source it may.

Neither can the force of this conclusion be diminished by the ingenious argument of the learned counsel, that the law punishes the act of making a fraudulent conveyance; and that penal statutes must be strictly construed.

It may be true, that a corporation cannot be punished criminally; but this forms no solid reason, why the law may not make reparation to the innocent, or secure the property of the creditor, from the operation of a fraud, the commission of which it is unwilling or unable to prevent.

But it is said, admitting this proposition to be true, the question of fraudulent intent is a question of fact for the determination of a jury; and that there was no evidence to warrant the Court in finding the fact of fraud. The case of Billings v. Billings is relied on by the counsel for the appellant, and in justice to myself, having participated in that decision, I must say the learned counsel gives to it a construction never intended by the Court. In that case the Court say, "that although the question of fraudulent intent is made a question of fact in all cases, yet whenever the law declares that certain evidence is conclusive of fraud, a verdict against such conclusive evidence should, in all cases, be set aside." The counsel for the appellant contends, that this language means that the verdict will be set aside, when contrary to the evidence proving a fraud in fact. A sufficient answer is found in the following portion of the opinion. "On the other hand, where the evidence of fraudulent intent is declared by law to be only presumptive, the jury have power, upon considering the whole case, to find against such presumption, and the Court would have no right on that ground alone, to interfere with the verdict." Would not the converse of the proposition be equally true; and if the case were submitted upon the presumptive evidence of fraud, and the fact of fraud found, would the Court have any right to disturb it? But say the Court, "The counsel for the appellant argued this cause upon the hypothesis that the District Court refused to decide, that the power to sell on credit was presumptive evidence of fraud. We cannot discover this by any thing in the record; if we did, we would not hesitate to reverse the judgment. The requests to the Court below are each accompanied with the same commencement, which asks the Court to decide that these assignments are void; holding as we do, that the power to sell on credit is not conclusive, but only presumptive evidence of fraud, it follows that the Court correctly refused to decide, that the deed was void on that ground; and the Court having also, in the capacity of a jury, passed upon the facts, and found against the presumption of fraud, there is no error."

The statute no where declares what will be conclusive or presumptive evidence of fraud. Where, then, are we to look for a definition? Certainly to the books. The rule of the English statute, which was only declaratory of the common law, is not changed by our law, except so far as it devolves, what was the duty of the Court, upon the jury.

It is impossible to imagine two cases more similar, than the present and the one just quoted, with the single exception, that the deed of conveyance in this case, bears upon its face conclusive evidence of fraud.

If we could not set aside the verdict in the case of Billings *v.* Billings, where there was acknowledged presumptive evidence of fraud, because the Court, setting as a jury, had found against the presumption, how can this Court properly set aside the verdict of the Court in this case, when it has found in favour of the presumption?

I have thus attempted to demonstrate that the conveyance to the Commissioners of the Sinking Fund, created by the common council, was void. 1st. For want of power in the council to organize such commission, or make such conveyance in trust. And 2nd, because said deed was within the statute of frauds. From which it follows, that the plaintiff's judgment became a lien upon the property of the city.

But it is contended if this should be the case, all these informalities, defects, and frauds, have been confirmed and ratified by an act of the legislature, passed May 1st, 1851, entitled, "An Act to fund the floating debt of San Francisco."

In support of the proposition that the legislature may confirm a void or fraudulent grant, a number of authorities have been cited, which I propose briefly to review.

In the case of Wilkinson *v.* Leland, 2 Peters, 672, the legislature of Rhode Island confirmed a void deed made by an executrix. It appears from the decision of the Court, that the property of the deceased, by the laws of Rhode Island, was liable for his debts. The executrix, residing in New Hampshire, had proceeded under the laws of that State, and had exhausted the property belonging to the estate, in New Hampshire, and afterwards sold the remaining property of her husband, lying in Rhode Island. At the time of said sale, she entered into an agreement with the purchasers of said property, to have said sale confirmed by the legislature of Rhode Island; as it was well understood the same was invalid, unless the will was admitted to probate, and the order of sale made by the courts of Rhode Island. Accordingly, a petition stating the facts, and also, that the sale of said property was necessary for the payment of the debts of the estate, and praying for a confirmation of said sale, was presented by said executrix, and the prayer granted by the legislature. The heirs of Cynthia Jenks afterwards brought ejectment. It was contended that this act was unconstitutional, and divested vested rights. The legislature of Rhode Island, acting under a charter granted by Charles the Second, had, at times, exercised all the powers of government—legislative, judicial, and executive; and, as was shown on the argument, had been frequently in the habit of granting new trials, and confirming void acts. Under the laws of Rhode Island, power to sell was granted, as a matter of course, without notice to heirs or devisees, on the mere production of proof from the Probate Court, of the deficiency of personal assets. A purchaser at the sale, upon receiving a deed from the executor or administrator, had a complete title, and was immediately under the deceased, and could enter and recover, notwithstanding any intermediate descents, sales, disseisins, or other transfers of title or seisin.

If therefore say the Court, "the whole real estate be necessary for the payment of the debts, the whole is sold, and the title of the heirs or devisees is by general operation of law divested and superseded.

"From this it appears, that the devisee under whom the present plaintiff claims, took the land in question, subject to the debts of the testator; her estate was a defeasible estate, subject to be divested. They have been divested of their formal title in another manner, in favour of creditors entitled to the estate, or rather their formal title has been made subservient to the paramount title of creditors. It is said this act divests, vested rights of property; but it has been already shown, that it divests no such rights, except in favour of existing liens, and that the estate was vested in the devisee expressly subject to said rights."

The Court further says, there is no pretence of fraud in the case, and although the law requires no notice, still it would be better in all such cases that notice should be given; but notice may be presumed after thirty years' acquiescence. How then does this case sustain the proposition contended for? Speaking upon the subject of divesting vested rights, in the same opinion the Court holds this strong language. "By the charter of Rhode Island the power to make laws is granted to the general assembly in the most ample manner, 'So as such laws be not repugnant unto, but as near as may be agreeable to, &c., the laws of England, considering the nature and constitution of the place and people therein.' In a government professing to regard the great rights of personal liberty and property, and which is required to legislate in subordination to the laws of England, it would not lightly be presumed the great principles of Magna Charta were to be disregarded, or that the estates of its subjects were to be taken away without trial, without notice, or offence even, if such authority could be deemed to have been granted by the charter of Rhode Island as an act of transcendental sovereignty before the Revolution. It can scarcely be supposed, that that great event left the people of that State, subject to its uncontrolled and arbitrary exercise. That government can scarcely be said to be free, where the rights of property are left solely dependent on the will of the legislative body without any restraint.

"The fundamental maxims of a free government seem to require, that the rights of personal liberty and private property should be held sacred, *at least no court of justice*, in this country, would be warranted in assuming that the power to disregard them—a power so repugnant to common principles of justice and civil liberty, lurked under a general grant of legislative authority, or ought to be implied from any general expression of the will of the people. The people ought not to be presumed to part with rights so vital to their security and well-being, without very strong and direct expressions of such intention. It has been held by this Court, that a grant of land made to a person or corporation, is irrevocable, and cannot be resumed by any subsequent legislative act; and that a different doctrine is utterly inconsistent with the great and fundamental principles of republican government, and with the right of the citizens to the free enjoyment of their property lawfully acquired.

"We know of no case in which a legislative act to transfer the property of A. to B. without his consent, has ever been held a constitutional exercise of legislative power in any State of the

Union. On the contrary, it has been constantly resisted, as inconsistent with just principles in every tribunal in which it has been attempted to be enforced. We are not prepared, therefore, to admit that the people of Rhode Island have ever delegated to their Legislature the power to divest vested rights of property, and transfer them without the assent of parties. *The counsel for the plaintiffs have admitted themselves, they cannot contend for such doctrine.*"

The next case relied upon, is the case of Saterlee *v.* Matthewson, 2 Peters. I have examined this case, as reported in 13th Sergeant and Rawle. This was an action of ejectment, brought for lands in Pennsylvania, originally obtained under a Connecticut title, and leased by the plaintiff to the defendant's father, in 1790; afterwards, in 1795, the legislature passed an act, declaring all contracts founded on Connecticut titles, void; and made it a criminal offence, to intrude under such titles.

In 1813, the plaintiff brought ejectment, and recovered; but the judgment was reversed in the Supreme Court, on the ground that the lease being founded on a Connecticut title, was void; afterwards, the legislature passed an act, declaring that the relation of landlord and tenant should exist upon such titles; and the Supreme Court of Pennsylvania affirmed the plaintiff's judgment, on the ground that the first law was passed after the contract of lease, and the disability created by such act, had been removed by the passage of the Act of 1826, and the parties remitted to their original rights: here the obligation of no contract was impaired, and the Supreme Court of the United States merely decided, so far as this case goes, that there is no *provision* of the Constitution of the United States, which prohibits States from passing laws divesting vested rights.

The case of Watson *v.* Mercer, 8th Peters, arose under a statute of Pennsylvania, confirming all defective acknowledgments of deeds. It was contended that this law divested vested rights, and impaired the obligation of contracts. But the Supreme Court of the United States again decided that there was no constitutional prohibition upon States passing such laws, unless they impaired the obligation of contracts; and that a law could not fairly be said so to do, which created a new, or confirmed an imperfect one. It was, in fact, but changing a rule of evidence—

there was no dispute as to the fact of the contract; and it was perfectly within the power of the legislature to say, that such acknowledgment should be good evidence of the acts of the parties.

In regard to private acts of parliament, and acts of alienation, Blackstone says, in vol. 2nd, chapter 21st: "Acts of this kind are however carried on in both houses, with great deliberation and caution, particularly in the House of Lords; they are usually referred to two judges, to examine and report the facts alleged, and to settle all technical forms; nothing is done without the consent expressly given of all parties in being, and capable of consent, that have the remotest interest in the matter, unless such consent shall appear to be perversely withheld; and a general saving is added at the close of the bill, of the rights and interests of all persons whatever, except those whose consent is given or purchased, and who are therein particularly named; though it hath been held, if such saving be omitted, it shall bind none but the parties."

In Cruise's Digest, vol. 5, p. 31, it is said that those acts are looked upon as private conveyances, rather than as the solemn acts of the legislature, and have been relieved against, when obtained upon fraudulent suggestions, and have been held void, if contrary to law and reason."

Chancellor Kent, in Chaplin *v.* Jackson, 8 Johns. Rep., says, when the suggestions on which the act is passed, are proved fraudulent, a court of chancery will relieve against them. In Watkins *v.* Holman, 16 Peters, the Court say, "If the administratrix and Brown have acted fraudulently in procuring the passage of the act, or in the sale under it, relief may be given on that ground." Here then is the whole doctrine upon this subject, both in England and the United States; from which it appears that Parliament which is said to be omnipotent, never affects the rights of third persons by such acts, and that unless entered into with good faith, and notice to all concerned, they are not binding.

But admitting for the present, that the Legislature have power to pass laws divesting vested rights, have they done so? and can their intention to confirm the void acts of the Common Council, and the deed to the Commissioners of the Sinking Fund, be fairly inferred from the language of the act?

The counsel for the appellant contends, that no express words are necessary to express a confirmation, and in support thereof, cites Comyn's Digest, and the case of Wilkinson *v.* Leland. Comyn, in speaking of confirmations between private individuals, uses the illustration quoted by the counsel. "If I say '*volo quod a habet*,' this is a sufficient confirmation." In Wilkinson *v.* Leland, it was urged by Mr. Webster, that the Legislature of Rhode Island, if acting as a court, should have used the language of a court, whereas they had resorted to that of a legislative body; and it did not sufficiently appear, that they intended to confirm the deed in question, but the Court say, "This is a legislative act, and must be interpreted according to the intention of the Legislature, apparent on its face; every technical rule of construction as to the force of particular terms, must yield to the paramount will of the Legislature, apparent on its face."

In this case the "*volo ut a habet*" of confirmations *inter partes* is nowhere expressed, neither can the intention of the Legislature to confirm these void acts be deduced by any fair rule of inference from the act reincorporating the city, or providing for funding its floating debt. The 14th section of the third act of the amended charter provides, that "all moneys derived from the following sources, shall continue to constitute a Sinking Fund."

Section 15. "The creditors of the city may fund the debts due them, &c."

Section 17. "The Commissioners of the Sinking Fund are prohibited from disposing of any property, *belonging* to the city, by lease or sale; and are required, on or before the 1st day of May next, to reconvey and deliver all property, rights, titles, and interest, belonging to the city, which are or may be in their possession."

The 12th section of the act to fund the floating debt "requires the Commissioners of the Sinking Fund to transfer to the Commissioners of the Funded Debt all property, &c., belonging to said city, which they have or may hereafter receive by virtue of article 3d of an act, entitled 'An act to reincorporate the city of San Francisco,' approved 14th April, 1851." What property did the Commissioners of the Funded Debt receive by the 3d article of the charter, or what was confirmed to them? No interest whatever. "*The paramount will of the Legislature expressed upon its face,*" confirming these acts, nowhere appears. On the contrary, if contemporaneous legislative exposition be entitled to any weight, it is clear that the Legislature never meant a confirmation; for, on the 28th of April, an act was passed confirming in express terms a contract entered into by these same commissioners for building Broadway wharf; on the 25th day of April, for building Market street wharf; and on the 5th day of April, for constructing the plank road to the mission of Dolores.

It appears from these acts, the Legislature understood the nature and form of confirmatory statutes, and it is hardly to be supposed, that in a matter involving so great an amount, as well as the rights of third persons, if they had designed a confirmation, they would not have expressed it in unmistakable language.

I can see no other object that the Legislature had in view, but to remove any legal doubt, as to the authority of one board of trustees to transfer to another board: and cannot presume the Legislature ever intended to usurp the functions of another branch of the government, by declaring that a fraud did not exist, or to interfere with the rights of third persons, unless express language be used to that effect.

But if I should be mistaken upon this point, it is still contended by the respondent, that the act of May 1st is unconstitutional, because it impairs the obligation of contracts. The decisions upon this point are by no means clear, and it is sometimes a difficult matter to distinguish between the right and the remedy. A law which creates a contract, it is said, cannot properly be said to impair the obligations of contracts. This is true, so far as it does not affect the rights and contracts of third persons. So the Legislature may, from time to time, alter or change the remedy; this they may do, provided they do not materially affect the right; but whenever the Legislature so far alter the remedy as to impede, destroy, change, or render the right scarcely worth pursuing, they necessarily impair the obligation of the contract upon which such right is founded, and the act is unconstitutional and void.

The leading cases on this subject are those of Bronson *v.* Kenzie, 1 Howard, and McCracken *v.* Hayward, 2 Howard.

The construction given to this clause in the Constitution, by the Supreme Court of the United States, has been adopted by the various State Courts, and is binding upon this Court. In this case the Legislature of Illinois passed a law subsequent to the execution of a mortgage, which declared that the equitable estate of the mortgagor should not be extinguished for twelve months after a sale, under a decree in chancery, and which prevented a sale, unless two-thirds of the amount for which the property was appraised, should be bid at the sale.

This cause was carried to the Supreme Court of the United States, on the ground that it impaired the obligation of contracts, and the act of the Illinois Legislature was held unconstitutional and void. In passing upon this case, the Court say, "If the laws of the State passed afterwards had done nothing more than change the remedy upon contracts of this description, they would be liable to no constitutional objection. For, undoubtedly a State may regulate at pleasure the modes of proceeding in its courts in relation to past contracts, as well as future. It may, for example, shorten the period of time in which claims shall be barred by the Statute of Limitations."

"Whatever belongs merely to the remedy may be altered, according to the will of the State, provided the alteration does not impair the obligation of the contract. But if that effect is produced, it is immaterial whether it is done by acting on the remedy or directly on the contract itself; in either case it is prohibited by the Constitution."

"If these acts so change the nature and extent of existing remedies as materially to impair the rights and interests of the owner, they are just as much a violation of the compact, as if they directly overturned his rights and interests."

"But it is manifest that the obligation of the contract, and the rights of a party under it, may, in effect, be destroyed by denying a remedy altogether; or may be seriously impaired by burdening the proceedings with new conditions and restrictions, so as to make the remedy hardly worth pursuing. And no one, we presume, would say, that there is any substantial difference between a retrospective law declaring a particular contract or class of contracts to be abrogated and void, and one which took away all remedy to enforce them, or encumbered it with conditions that rendered it useless or impracticable to pursue it."

"This brings us to examine the statutes of Illinois, which have given rise to this controversy. As concerns the law of February 19th, 1841, it appears to the Court not to act merely on the remedy, but directly upon the contract itself, and to engraft upon it new conditions, injurious and unjust to the mortgagee. It declares, that although the mortgaged premises should be sold under the decree of the court of chancery, yet, that the equitable estate of the mortgagor shall not be extinguished, but shall continue for twelve months after the sale: and it moreover gives a new and like estate, which before had no existence, to the judgment creditor, to continue for fifteen months. If such rights may be added to the original contract, by subsequent legislation, it would be difficult to say at what point they must stop."

"This law gives to the mortgagor and to the judgment creditor, an equitable estate in the premises, which neither of them would have been entitled to, under the original contract; and these new interests are directly and materially in conflict with those which the mortgagee acquired when the mortgage was made. Any such modification of a contract, by subsequent legislation, against the consent of one of the parties, unquestionably impairs its obligations, and is prohibited by the Constitution."

In the case of McCracken *v.* Hayward, 2nd Peters, it was decided that a law of Illinois, providing that property should not be sold at sheriff's sale, unless it brought two-thirds of its valuation, according to the opinion of three householders, was unconstitutional and void: in that case the Court say, "In placing the obligations of contracts under the protection of the Constitution, its framers looked to the essentials of the contract, more than to the forms and modes of proceeding, by which it was to be carried into execution: annulling all State legislation which impaired the obligation, it was left to the States to prescribe and shape the remedy to enforce it. The obligation of a contract consists in its binding force on the party who makes it. This depends on the laws in existence where it is made; these are necessarily referred to in all contracts, and forming a part of them, as the measure of the obligation to perform them by the one party, and the right acquired by the other. There can be no other standard by which to ascertain the extent of either, than that which the terms of the contract indicate, according to their settled legal meaning; when it becomes consummated, the law defines the duty and the right, compels one party to perform the thing contracted for, and gives the other the right to enforce the performance by the remedies then in force. If any subsequent law affect to diminish the duty, or to impair the right, it necessarily bears on the obligation of the contract in favour of one party, to the injury of the other; hence, any law, which, in its operation amounts to a denial, or obstruction of the rights accruing by a contract, though professing to act only on the remedy, is directly obnoxious to the prohibition of the Constitution."

"The obligation of the contract between the parties, in this case was, to perform the premises and undertakings contained therein; the right of the plaintiff was to damages for the breach thereof, to bring suit and obtain a judgment, to take out and prosecute an execution against the defendant till the judgment was satisfied, pursuant to the existent laws of Illinois."

"These laws giving these rights, were as perfectly binding on the defendant, and as much a part of the contract, as if they had been set forth in its stipulations in the very words of the law, relating to judgments and executions. If the defendant had made such an agreement as to authorize a sale of his property, which should be levied on by the sheriff, for such price as should be bid for it at a fair public sale on reasonable notice, it would have conferred a right on the plaintiff, which the constitution made inviolable; and it can make no difference, whether such right is conferred by the terms or law of the contract. Any subsequent law which denies, obstructs or impairs this right, by superadding a condition, that there shall be no sale for any sum less than the value of the property levied on, to be ascertained by appraisement, or any other mode of valuation than a public sale, affects the obligation of the contract as much in the one case, as the other; for it can be enforced only by a sale of the defendants' property, and the prevention of such sale is the denial of a right.

"The same power in a State Legislature may be carried to any extent, if it exists at all; it may prohibit a sale for less than the whole appraised value, or for three-fourths or nine-tenths, as well as for two-thirds; for if the power can be exercised to any extent, its exercise must be a matter of uncontrollable discretion in passing laws relating to the remedy, which are regardless of the effect or the right of the plaintiff."

This same question was afterwards considered by the Supreme Court of New York, in the case of Quackenbush *v.* Dowks, 1 Denio, in which it was held, that a law of New York exempting property from distress for rent and sale on execution, did not affect executions for debts contracted before its passage, and that said law conflicted with the Constitution of the United States prohibiting any State from passing laws impairing the obligation of contracts. Chief Justice Bronson, in delivering the opinion of the Court, says, "Imprisonment as a means of enforcing the payment of debts no longer exists. The creditor can look to nothing but the property of the debtor. If the Legislature can deprive him of the right to reach property—a right which existed at the time the contract was made—it is evident that nothing will then remain of the obligation of the contract beyond an empty name. It may be moral, but it is no longer the legal duty of the debtor to pay. For all honest and practical purposes, the Legislature might just as well say, that the debt shall be blotted out, as to deny to the creditor all means of enforcing payment. I have not overlooked the distinction, which often exists between the obligation of the contract, and the remedy to enforce performance. In many cases, this distinction is of a substantial nature, and must have a controlling influence. But experience has proved that laws which in form go only to the remedy, may have the practical effect of nullifying the contract. This has been seen by the Federal Courts, and they have recently laid down some very important qualifications to the general doctrine, that the States have unlimited power over the remedy. I shall not enter at large into the discussion of this question, for the reason that, I think it virtually settled by the late decisions of the Supreme Court of the United States, in the cases arising under the valuation laws of the State of Illinois, (Bronson *v.* Kenzie, 1 Howard, 311; M'Cracken *v.* Hawyard, 2 id. 608.) I allude more particularly to the last of these cases, which arose upon a statute touching sales on execution. The laws provided that when execution should be levied on any property, real or personal, it should be the duty of the officer to summon three householders, who, after being duly sworn, should 'fairly and impartially value the property;' and when offered for sale, it should not be struck off, unless two-thirds of the amount of such valuation should be bid therefor. This law which was passed after the creditor had obtained a judgment, was held to be unconstitutional and void. If a law which only prohibits the creditor from taking the property at less than two-thirds of its sworn value, cannot be supported, it needs no argument to prove that a law cannot be upheld, which wholly withdraws the property from the reach of the creditor. As the question arises under the Constitution of the United States, we must regard the decision as one of binding authority."

There is, I think, no well defined middle ground, between holding, that none of the debtor's property can, by a subsequent law, be withdrawn from the reach of the creditor, or else, admitting that the whole of his estate may be exempted from sale on execution. In the case before us, the exemption law saves all to the debtor; but my opinion would be the same, if it had only saved a part. Such property as was subject to execution at the time the debt was contracted, must remain subject to execution, until the debt is paid. As to future obligations, the legislature may make the exemption as broad as it pleases. It may abolish credit altogether, but it cannot legislate backward, and annul the force of prior obligations."

If an act, which gives to the mortgagors the right to redeem in twelve months, or provides that property shall not be sold for less than two-thirds of its value, or which exempts the necessary property of the poor and indigent, is unconstitutional, how much more so is an act which divests the creditor's lien altogether? Which exempts the property of the judgment debtor from execution, places it in the hands of trustees, with power to sell, as they may think proper, and compels the creditor, if he wishes any benefit whatever, to fund his scrip at a less rate of interest, and submit to the delay of twenty years, without any guaranty that he will then receive the principal. Such are the provisions of the act to fund the indebtedness of the city. The property out of which the creditor had a right to make his money, is attempted to be withdrawn, and the remedy he possessed so far impaired, as to make his right worthless.

The law, therefore, is unconstitutional and void, as against the plaintiff in this case.

It has, however, been contended, that if the Court should come to the conclusion to which it has now arrived, that the Act of April 15th, 1851, re-incorporating the City of San Francisco, repealed the old corporation, and consequently its debts became extinguished, and its property escheated to the State. That the State, in the exercise of her sovereignty, has reconveyed the property of the city to the fund commissioners, coupled with the condition of the payment of the floating debt of the city.

It requires no little courtesy to discuss this proposition seriously, even for a moment; and the whole mistake has grown out of a failure to distinguish the difference between the body politic, as a corporation, and the act constituting it a corporation. The title of the act is, "An Act to re-incorporate the City of San Francisco." The first section provides, "The people of the City of San Francisco *shall continue* to be a body politic and corporate, under the name and style of the City of San Francisco."

By the first charter, the people of San Francisco are constituted "a body politic;" the second continues, not destroys, the body so founded.

In the language of Lord Mansfield, "It has never been disputed, that new charters revive, and give activity, to the old corporation; where the question has arisen, in which there was any remarkable metamorphosis, it has always been determined that they remain the same, as to debts and rights." Angell & Ames on Corporations, 780; Hopkins *v.* Swansea, 4 M. & W. In the case of Bellows *v.* The President, Directors, and Company of Hallowell and Augusta Bank, Judge Story lays down the rule, that we must look to the terms of the charter, to ascertain whether a new corporation is created, or merely an old one continued. In fact, the legislature possess no such arbitrary power, to seize the revenues and property of a municipal corporation. If they had, by what authority, the debt having once been destroyed, can they again revive, and impose it upon this city? and authorize a large tax to be levied upon the corporators, for its payment?

The construction contended for is at war with the plain and obvious meaning of the Legislature, and even if such were the intention, it would be but doing indirectly what I have already shown they cannot do directly, and would therefore be unconstitutional and void.

It was contended upon the argument of this case, that the City of San Francisco had no title to a portion of the property in question. It is admitted in the agreed case, that the title was in the City so far as the question of the right to sell the water property of the City is concerned. The City is estopped from setting up any right in the State. She cannot take advantage of her own wrong by showing an indebtedness to the State. The Sheriff merely sold the right, title and interest of the City. And whenever the State chooses to assert her right in the premises, it will be time enough for this Court to determine the character of the title which the plaintiff acquired.

The next objection taken by the appellant, is to the mode of levy and sale of the water lots in question. It is contended, that the City never had any thing but a leasehold interest in the water lot property; that the judgment is not a lien; and the Sheriff cannot levy upon it, without an actual mancaption or seizure; that he must levy and sell it as a chattel, within view of those attending, and deliver possession to the purchaser.

At common law, the mode of selling chattels personal and chattels real was essentially different. In the first place, personal chattels were sold in view of the purchaser, and he was immediately put into possession of them.

In the sale of chattels real, the sheriff executed a deed, and the purchaser was left to his remedy at law to obtain possession. Playfair *v.* Musgrove, 14 Mees. & Wels.; Rex *v.* Dean et al, 2 Shower.

By the Statute of 1850, under which the sale was made, the mode of selling chattels real and personal is not the same, whilst that of selling chattels real and real estate is. Sect. 172, chap. 25, Statutes of 1850, provides that the filing of a judgment with the Recorder of a county shall create a lien upon all the real estate of the judgment debtor, within the county in which the transcript is so filed. Sect. 181, provides that an execution shall create no lien upon personal property, except upon personal property actually levied upon. Sect. 190, provides for the judgment debtor giving bond for the forth-coming of the personal property. Sect. 196. "No personal property shall be offered for sale unless the same be present and within view of those attending the sale, provided, &c."

The 197th section provides, when real estate "has been taken in execution, it shall be sold at the county-seat of the county in which it is situated, at the door of the Court-house:" Sect. 207, "The officer who shall sell any real estate or lease of lands for more than one year; shall make to the purchaser a deed reciting the facts, &c." The deed shall convey to the purchaser all the right, title and interest which the defendant had at the time of filing the transcript in the Recorder's Office, &c."

From these sections, it is evident that personal property must be actually seized and sold in presence of the purchaser; while a lien immediately attaches to real estate, upon the filing of the transcript, and that the same is to be sold in front of the court house door, and that all leasehold estates, of more than one year, are to be so disposed of. In fact, from the very nature of such estates, it would be a moral and physical impossibility to levy upon and sell them in the mode pointed out, in regard to personal property; to attempt which, would involve an absurdity never contemplated by the law.

It is said that the clerk had no authority to issue the writ of *venditioni exponas*, and the sheriff had no authority to sell under it.

The execution first issued in this case, was a perfect power to the sheriff to sell, and when he levied, the property so levied on, was in legal contemplation in his possession, and it was his duty to sell; if he did not sell before the return, it was nevertheless his duty to sell. The writ of *venditioni exponas*, at common law, gave the sheriff no new power, but compelled him to proceed on motion of the plaintiff. This writ, or order, was a common law right of the plaintiff, (2 Tidd, 1020.) It is even said, if the sheriff seize sufficient property, and return the writ, he is bound to find buyers. The sheriff may also sell, after he goes out of office, upon an old and expired levy, made while in office, without a *venditioni exponas*, (ibid. 1013,) and the authorities there quoted.

If such were not the case, any informality in this respect is cured by the 8th, 9th, and 10th sections of the act to regulate proceedings in the district courts. Statute 1850, p. 24, which authorize the Court to "frame new writs and process, and to issue all such executions and other writs, as may be necessary to carry their judgments into full force and effect."

I have thus attempted to demonstrate that the act of the City of San Francisco, creating the "Board of Sinking Fund Commissioners," and the deed executed to them, of all the property of the city, is void, for want of power in the city, and also, because said deed is within the statute of frauds.

That the Act of May 1st, funding the debt of the city, is unconstitutional, so far as the rights of the plaintiffs are affected thereby, and that the levy and sale by the sheriff, are regular and valid.

Whether this be a controversy between speculators at the sheriff's sale and the city, as urged by the appellant's counsel, is a matter with which this Court has no concern.

The plaintiff was an honest creditor of the city, and as such, entitled to be paid: if, in attempting to shuffle off this debt, the city has lost her patrimony, the censure must fall on those who have permitted so great a sacrifice. This Court cannot warp the stern rules of law, to relieve against the apparent hardship of the case, or to defeat rights properly and legally acquired.

Judgment affirmed, with costs.

A motion was made for a re-hearing, which was overruled, and the judgment affirmed in all particulars.

TAB 13

90054 041

SUPREME COURT OF ONTARIO 10110/83

BETWEEN:

THOMAS FLYNN & SONS CONSTRUCTION
(TORONTO) LIMITED
Plaintiff

and

RONALD LAPORTE AND OPTIMUM CONTRACTING
LIMITED
Defendants

H. M. Pattison for Plaintiff.
W. R. Hunter for Defendants.

REID J.

Plaintiff was a subcontractor for Lap-Ron Construction Ltd. a company owned by defendant Laporte, on a substantial contract to outfit ice cream parlours in southern Ontario for Ontario Dairy Products Limited. Ontario Dairy ran into financial difficulties, and in 1982 could not pay Lap-Ron's outstanding account. This in turn caused Lap-Ron difficulty in paying its creditors.

By the summer of 1982, Lap-Ron owed Plaintiff $19,563.96 on the Ontario Dairies contract. On September 10, 1982, after repeated requests for payment, Plaintiff issued a specially endorsed Writ of Summons against Lap-Ron and Ontario Dairy claiming payment of $23,029.74 (the first action). On January 27, 1983, Plaintiff moved successfully for judgment against Lap-Ron for part of its claim in the amount of $15,205.96 This judgment remains unsatisfied.

On June 7, 1983 a judgment debtor examination of Laporte as President of Lap-Ron revealed to Plaintiff for the first time the existence of Optimum, a company of which Laporte is as well the President and sole shareholder. That revelation led to the present action (this action) being commenced on September 1, 1983.

The Writ of Summons in the first action had been served on Lap-Ron on September 20, 1982. On October 1, 1982, Laporte caused two written agreements to be made between Lap-Ron and Optimum. The first transferred Lap-Ron's office equipment to Optimum for a consideration of $2200.00. The second transferred other Lap-Ron assets, including a truck, a van, two saws and a planer for a consideration of $3,350.00. Laporte executed both agreements on behalf of both companies and his secretary witnessed them. The agreements provided for payment by June 30, 1983 and March 1, 1983 respectively. On December 15, 1982 Laporte caused another written agreement to be made, again under his signature for both parties, transferring to him personally Lap-Ron's company car, a 1981 Oldsmobile Cutlass, in consideration of $1.00 and his assumption of the obligation to pay the balance owing on its purchase. This vehicle later appeared on the books of Optimum.

Lap-Ron made an assignment in bankruptcy on June 8, 1984.

On July 10, 1985 Plaintiff obtained an order enabling it to continue this action pursuant to s.20 of the *Bankruptcy Act*, R.S.C., c.14. The order reads, in part,

> 1. THIS COURT ORDERS THAT Thomas Flynn & Sons Construction (Toronto) Ltd. are hereby authorized and may proceed with an action commenced in the Supreme Court of Ontario in the Judicial District of York at Toronto bearing action number 10110/83 in its own name and at its own expense and risk for the purpose of obtaining an Order setting aside certain conveyances made by the within bankrupt to Ronald Laporte and Optimum Contracting Limited.

The order went on to provide for other creditors to join in the action with Plaintiff if they saw fit. None did.

Plaintiff relies principally on s. 2 of the *Fraudulent Conveyances Act* R.S.O. 1980, c.176. Sections1-4 of that Act read,

1. In this Act,

(a) "conveyance" includes gift, grant, alienation, bargain, charge, encumbrance, limitation of use or uses of, in , to or out of real property or personal property by writing or otherwise;

(b) "personal property" includes goods, chattels, effects, bills, bonds, notes and securities, and shares, dividends, premiums and bonuses in a bank, company or corporation, and any interest therein;

(c) "real property" includes lands, tenements, hereditaments and any estate or interest therein.

2. Every conveyance of real property or personal property and every bond, suit, judgment and execution heretofore or hereafter made with intent to defeat, hinder, delay or defraud creditors or others of their just and lawful actions, suits, debts, accounts, damages, penalties or forfeitures are void as against such persons and their assigns.

3. Section 2 does not apply to an estate or interest in real property or personal property conveyed upon good consideration and bona fide to a person not having at the time of the conveyance to him notice or knowledge of the intent set forth in that section.

4. Section 2 applies to every conveyance executed with the intent set forth in that section notwithstanding that it was executed upon a valuable consideration and with the intention, as between the parties to it, of actually transferring to and for the benefit of the transferee the interest expressed to be thereby transferred, unless it is protected under

> section 3 by reason of bona fides and want of notice or knowledge on the part of the purchaser.

Plaintiff relies also on ss.-s 4(1) and 12(1) of the *Assignments and Preferences Act*, R.S.O. 1980, c.33 which reads,

> 4. - (1) Subject to section 5, every gift, conveyance, assignment or transfer, delivery or over payment of goods, chattels or effects, or of bills, bonds, notes or securities, or of shares, dividends, premiums or bonus in any bank, company or corporation, or of any other property, real or personal, made by a person at a time when he is in insolvent circumstances or is unable to pay his debts in full, or knows that he is on the eve of insolvency, with intent to defeat, hinder, delay or prejudice his creditors, or any one or more of them, is void as against the creditor or creditors injured, delayed or prejudiced.
>
> 12.-(1) In the case of a gift, conveyance, assignment or transfer of any property, real or personal, that is invalid against creditors, if the person to whom the gift, conveyance, assignment or transfer was made has sold or disposed of, realized or collected the property or any part thereof, the money or other proceeds may be seized or recovered in an action by a person who would be entitled to seize and recover the property if it had remained in the possession or control of the debtor or of the person to whom the gift, conveyance, transfer, delivery or payment was made, and such right to seize and recover belongs not only to an assignee for the general benefit of the creditors of the debtor but, where there is no such assignment, to all creditors of the debtor.

The foregoing provisions are referred to hereafter for convenience as "the legislation".

Plaintiff makes the following claims for relief in paragraph 12 of its statement of claim:

> a) such amounts as may be found appropriated or due to Lap-Ron Construction Limited by the Defendants or either of them;
>
> b) interest on any sums found to be appropriated or wrongly given preference by the Defendants to any other creditor and the amounts to which the other Creditors or Defendants were given preferences;
>
> b.1) a declaration that the conveyance of any and all assets or property of Lap-Ron Construction Limited to Optimum Contracting Limited is void;
>
> b.2) a declaration that the conveyance of any assets and property of Lap-Ron Construction Limited to Optimum Contracting Limited, including the ongoing business of Lap-Ron Construction Limited, be set aside;
>
> b.3) damages in the amount of $30,000.00;
>
> c) exemplary and punitive damages in the amount of $25,000.00;
>
> d) pre-judgment interest on the aforesaid sums pursuant to the relevant provisions of the *Judicature Act*, R.S.O. 1980, c.223 and the relevant amendments thereto;
>
> e) post-judgment interest on the aforesaid sums pursuant to the relevant provisions of the *Judicature*

Act, R.S.O. 1980, c.223 and the relevant amendments thereto;

f) their costs of this action.

It was overwhelmingly established in evidence that the written conveyances were part of a scheme contrived by Laporte, when he realized that Lap-Ron was insolvent or about to be, to defeat Lap-Ron's creditors. Laporte testified that as a result of Ontario Dairy's failure to pay Lap-Ron's account Lap-Ron was unable to pay its creditors. Laporte entreated his creditors for indulgence but that stratagem failed for Ontario Dairy continued to default and ultimately became bankrupt on June 8, 1984. By September, 1982, Lap-Ron was clearly no longer viable. Laporte embarked on a course of action which allowed it to die by taking on new business in the name of Optimum, a company he had incorporated in1972 but which had been inactive since 1977. He held creditors at bay with promises of payment.

To ensure that services essential to the operation of Optimum, such as the telephone, would continue, Laporte paid, or arranged for payment, of what Lap-Ron owed for them. He was thus able, in effect, to continue Lap-Ron's business under Optimum's name by paying Lap-Ron's debts to such of its suppliers and for such of its services as were necessary to the operation of Optimum. The fact that there are many companies able to do Plaintiff's kind of work meant that Plaintiff was not essential to Optimum's business operations. That made it possible for Laporte to choose not to pay its account, or, for that matter, the accounts of other non-essential unpaid sub-contractors. Being able to pick and choose, Laporte paid some sub-contractors, and continued to use them, but Plaintiff was not in that fortunate group. Probably because of Laporte's repeated assurances that they would be paid, none of Lap-Ron's creditors initiated bankruptcy proceedings. Laporte was thus able to continue this policy of diverting Lap-Ron business to Optimum. Without the burden of Lap-Ron's debt Optimum flourished. It was not until June 8, 1984, that Laporte finally consigned Lap-Ron to bankruptcy, and killed it off.

It is clear that the written agreements of October 1st and December 15th were made when Lap-Ron was insolvent and with the intent to defeat or prefer creditors. They thus fall clearly within the legislation.

The legislation is not confined by its terms to written conveyances. Indeed, s.1(a) of the *Fraudulent Conveyances Act* refers to a conveyance "in writing or otherwise." This is significant because the largest transfers were not made by written conveyances. When Laporte saw that Lap-Ron would not be able to carry on he did nothing really more than take down Lap-Ron's sign and hoist Optimum's. He carried on the same business from the same premises, with the same phone number, the same customers, the same office equipment, the same employees, some of the same customers, some of the same suppliers, and some of the same sub-contractors. The most important asset of the business was no doubt his own services, which he simply applied to the interests of Optimum instead of Lap-Ron. Lap-Ron's entire inventory, stock-in-trade, and work-in-progress was taken over by Optimum, and thus transferred just as effectively as if there had been written conveyances for every asset, signed, sealed, and delivered. Sales secured by Lap-Ron were credited to Optimum. No consideration was given for anything transferred outside the written agreements. The evidence of the value of what was transferred outside the written agreements differed somewhat. The witness Delaney' s evidence was that Lap-Ron had inventory in the amount of some $3000.00 and sales of $13,300.00 which were transferred in effect to Optimum (the costs associated with these sales were left in Lap-Ron). While the unaudited books prepared by Laporte's secretary and her testimony and Laporte's are at odds with Delaney's conclusions, I accept Delaney's evidence. I found Laporte's credibility questionable. His secretary's obvious loyalty in my opinion might well have affected her objectivity.

Since it is clear that by written and "silent" transfers Laporte caused every asset possessed by Lap-Ron to be conveyed to Optimim because Lap-Ron could no longer pay its creditors and for the purpose of defeating creditors all of the transfers are void. The definition of conveyance in the legislation is wide enough to include transfers made without consideration.

Under the heading "Damages" Plaintiff claims to be owed $30,000.00. This amount was broken down as follows:

(a) $15,205.96 Plaintiff's summary judgment of January 27, 1983 against Lap-Ron not including costs, interest or the balance of the claim on the specially endorsed writ;

(b) $4,358.00 The balance of the Plaintiff's claim against Lap-Ron on the writ;

(c) $1,853.04 Prejudgment interest at 16% on item (a) above from April 24, 1982 to January 27, 1983 (a liquidated amount claimed and calculated in accordance with Section 36 of the Judicature Act);

(d) $384.63 The costs of the motion awarded to the Plaintiff on January 27, 1983 by the judgment;

(e) $1,113.55 Postjudgment interest on items (a) and (d) above at 11% from January 27, 1983 to the date of the commencement of this action, being September 21, 1983 (calculated in accordance with Section 37 of the *Judicature Act*)

(f) $531.08 Prejudgment interest on item (b) from April 24, 1982 to January 27, 1983 at 16%;

(g) $311.27 Prejudgment interest on item (b) from January 27, 1983 to September 21, 1983 at 11%;

(h) $500.00 An allowance for the costs incurred for the prosecution of the Plaintiff's action for the balance of its claim, to date.

Total $24,257.53.

Of these, item (a) is clearly established as a debt owing but item (b) is still to be litigated. I do not think it can fairly be said that the balance of the original claim was placed in issue in the hearing before me. Items (c) to (e) were made out, but (f) and (g) fall with (b). I know of no basis for an award of costs for a proceeding that might not be pursued and therefore disallow item (h). Thus Plaintiff is entitled to recover the sum of items (a) and (c) to (e) or $18,557.18.

In addition to the foregoing Plaintiff claimed to be owed a balance of $912.00 left unpaid on the December 15th agreement. The issue was fully gone into at trial and I see no reason why it should not be included. Laporte claimed that he had paid some of Lap-Ron's debts personally and sought to set such payments off against this claim. I found his evidence on this as on other matters unconvincing. He admitted that he had falsified the value of the Oldsmobile when reporting the transfer to the government (in a declaration for motor vehicle transfer retail sales tax purposes) and sought to excuse this on the basis that everyone cheated. This attitude is characteristic of the man. It was at the heart of his devious scheme to lead his creditors to think they would be paid while arranging his affairs to ensure that they would not. His attitude led me strongly to doubt his credibility. I find that the $912.00 is still owing. Plaintiff is therefore owed by Lap-Ron a total of $19,469.18 plus postjudgment interest from the date of the commencement of this action to the date of payment at the rate of 11%. Since 2334 days have passed between the date of commencement and the date of judgment, a further $10,946.46 in interest is owing. Thus Plaintiff is owed a total of $30,415.64 plus $4.69 [11%/365 x (384.63 + 15,205.96)] in interest per day starting February 13, 1990 until payment.

The relief available under s. 2 of the *Fraudulent Conveyances Act* and ss. 4(1) of the *Assignment and Preferences Act* is the return of the property conveyed. However, ss. 12(1) of the latter enables the Plaintiff to recover the proceeds of disposition or realization where the property has been disposed of or realized. It is obvious that the inventory and the sales conveyed have been realized, and Plaintiff is therefore entitled to recovery from Optimum against Lap-Ron's debt to the extent of $16,300, the value of the wrongfully transferred inventory and sales. Interest should be added to that amount from October 1st, 1982, a date I deem to be the date of the transfers as evidenced by the first written agreement, for I find that Laporte was carrying on Lap-Ron's business under Optimum's name by at least that date. The rate shall be the prime rate in the month preceding the month on which the action was commenced in accordance with s.36 of the *Judicature Act*, R.S.O. 1980, c.223, i.e. 11% from the date the cause of action arose, October 1, 1982, to the date of judgment, February 12, 1990. The per diem interest owing is thus $4.91 (11%/ 365 X $16,300). 2690 days have passed since the cause of action arose. Thus $16,300.00 plus $13,207.90 ($4.91 X 2690) in interest is owing, for a total value of property fraudulently conveyed of $29,507.90. Plaintiff is also entitled to postjudgment interest on the $16,300.00 according to s.137(1)(c) of the *Courts of Justice Act, 1984* as amended.

Plaintiff is entitled to judgment in accordance with the foregoing. Plaintiff is as well entitled to an order setting aside the written conveyances. With respect to the latter, the amount Plaintiff would be entitled to recover from Optimum towards what it is owed cannot be determined on the evidence placed before me. A reference would be required. If Plaintiff desires to proceed in this way it may apply for directions

I do not think that a case has been made out for exemplary or punitive damages.

Since the conveyances that gave rise to this action were fraudulent Plaintiff shall have its costs of this action on a solicitor and client scale payable by Optimum and Laporte as the perpetration. The amount of those costs is recoverable from the Defendants without regard to the amount Plaintiff recovers from Optimum for Lap-Ron's fraudulent conveyances.

I have endorsed the record as follows: Judgment for Plaintiff against Defendant Optimum in the amount of $29,507.90 and costs payable by both Defendants on a solicitor and client scale.

12 February 1990 R. Reid

TAB 14

grant or demise, and who had a trust reposed in him by his lessor or grantor, which fraud and practice is so secretly (*a*) contrived, that the [80 a] lessor by common presumption could not have notice to make his claim, because his lessee continued in possession, and paid his rent, as a lessee ought. And as to that which was objected, that it would be mischievous to avoid fines on such bare averments: it was answered, that it would be a greater mischief, and principally in these days (in which as the poet saith,

———Fugere pudor, rectumque, fidesque,
In quorum subiere locum fraudesque, dolique,
Insidiæque, & vis, & amor sceleratus habendi.)

if fines levied by such covin and practice should bind; such objection may be made, (*a*) and if a fine be levied to secret uses to deceive a purchaser, an averment of fraud may be taken against it, by the stat. of 27 Eliz. cap. 4. So if a fine be levied on an usurious contract, it may be avoided by (*b*) averment, by the statute of 13 Eliz. cap. 8. (A 1). And Sir Thomas Egerton Lord Keeper of the Great Seal, commended this resolution of the justices, and agreed in opinion with them (2).

[80 b] TWYNE'S CASE.

Mich. 44 Eliz.

In the Star Chamber. 1601.

[S. C. 1 Sm. L. C. 1. See "*The Heart of Oak,*" 1869, 39 L. J. Adm. 19; *Ex parte Wilson*, 1874, 29 L. T. 861; *Cookson* v. *Swire*, 1884, 9 App. Cas. 664; *Ex parte Chaplin*, 1884, 26 Ch. D. 333; *In re Telescriptor Syndicate, Limited* [1903], 2 Ch. 189.]

S. C. Moor, 638. S. C. cited acc. Lane 44, 45. 47. Co. Lit. 3 b. 76 a. 290 a. 3 Keb. 259. [1 Saund. 66 (1). 1 Mod. 119. 1 Ld. Raym. 286. 2 Ld. Raym. 1459. 1 Dougl. 87. 296. 1 Cowp. 233. 280. 2 Cowp. 433. 631. 708. 712. 1 Burr. 85. 2 Burr. 831. 1 Ves. sen. 350. 1 Atk. 16. 162. 2 Atk. 512. 600. 1 Bro. C. C. 99. 2 T. R. 463. 591. 4 T. R. 57. 5 T. R. 237, 422. 7 T. R. 70, 1, 2. 3 Esp. 53. 4 East, 13. 6 East, 265. 267, 268. 273. 15 East, 25. 2 Bos. & P. 60. 3 Taunt. 244. 258. 5 Taunt. 218. 734. 7 Taunt. 151. 2 Marsh. 428. 1 Moore C. P. Rep. 193. 5 Ves. 870. 874. 10 Ves. 145. 11 Ves. 7. 17 Ves. 197. 1 Eden, 168. 1 Inst. ii. 237, 238. (O). 3 Wood, 1. Shep. Touch. 64, 65, 66, 67. Gilb. Us. 173. 3rd. edit. 371. and n. (5). *ib.* 2 Bl. Com. 441. 444. 1 Fearne Cont. Rem. 476. Bull. N. P. 257 b. 258 a. 260. 1 Sand. Us. 158. 1 Fonbl. Tr. Eq. 272, 273. 278, 279, 280 n. 2 Fonbl. Tr. Eq. 26. 1 Madd. Ch. 2nd. edit. 278. 4 Cru. Dig. 517. 526, 527. V. 214. Pow. Mortg. 31. 1 Mont. B. L. 41. Sugd. Pow. 410,

(*a*) 2 Rol. Rep. 17.

(*a*) Plowd. 49 b. 7 Co. 39 b. [5 Cru. Dig. 299. 1 Prest. Conv. 264. Vin. Abr. Fine I. b. 4. Fraud K. a. pl. 2. Bac. Abr. Fines H. *Ante*, p. 78 b. n. (o).]

(*b*) Jenk. Cent. 254. 9 Co. 26 b. See n. (A 1). *infra*, and the books there cited.

(A 1) Acc. *Dodd* v. *Ellington*, Rol. Rep. 41. pl. 8. Brownl. 191. 5 Cru. Dig. 299. Vin. Abr. Fine E. b. 3. pl. 6, 7. Usury I. pl. 4. Shep. Touch. 19. A fine obtained by fraud will be relieved against in equity, which considers the person deriving title under it as a trustee; and the species of relief is by directing a reconveyance, *Pickett* v. *Loggan*, 14 Ves. 234. *Wright* v. *Booth*, Tot. 101. *Coleby* v. *Smith*, 1 Vern. 205. *Woodhouse* v. *Brayfield*, 2 Vern. 307. *Cartwright* v. *Pulteney*, 2 Atk. 381. *Baker* v. *Pritchard*, 2 Atk. 387. *Barnsley* v. *Powell*, 1 Ves. 289. 5 Cru. Dig. 299, 300. 1 Prest. Conv. 253. 264. 1 Madd. Ch. 266. As to equitable jurisdiction in cases of fraud, see *id.* 109, &c. Com. Dig. Chancery 3. F. Vin. Abr. Chancery N. (ED.)

(2) [Note also, no fine can avoid an antecedent charge, but the estate will be bound, notwithstanding such fine, &c. See 2 Bl. Com. ch. 11. fol. 356, 357. *Note to the former editions.* See *ante* i. p. 62 a. n. (F 1).] (ED.)

411. 414. Sugd. Vendors 574, 575. 6 Bart. Prec. 220. 2 Tidd. Prac. 1041. 1043. 1 Evan. Stat. 391 n. 393, 394. Vin. Abr. Condition Y. pl. 7. Faits E. a. pl. 13. Fraud. C. pl. 2. 9. F. pl. 1. 6, 7. 13. I. pl. 7. 10. K. pl. 2. L. pl. 2, 3, 4, 5. Grants U. pl. 4. Offices O. 3. pl. 3. Void or Voidable A. pl. 8. Uses A. pl. 1, 2, 3. S. 3. pl. 21. Com. Dig. Covin B. 2, 3, 4. Uses D. 2. Bac. Abr. Agreement B. 2. Condition K. Fines and Recoveries F. iii. 209. Fraud C. iii. 307. 310, 311, 312, 313. Outlawry D. 2. 2. Y. 227. See the references and notes *infra.*]

A. indebted to B. in four hundred pounds, and to C. in two hundred pounds, being sued in debt by C., pending the writ, makes a secret assignment of all his goods and chattels in B. generally, without exception, in satisfaction of his debt, but still continues in possession, and sells some sheep, and sets his mark on others; held that this was a fraudulent gift within the 13 Eliz. c. 5. 1st. Because the gift was general, without exception of his apparel, &c.; the donor continued in possession, and used them as his own; it was made in secret, pending the writ; there was a trust between the parties; and the deed contained an unusual clause,—that it was made *bona fide*, &c. 2nd. That a good consideration is not sufficient to take a case out of the statute, unless the deed be made *bona fide* also.

What conveyances are fraudulent within the 13 Eliz. c. 5. and 27 Eliz. c. 4.

Statutes made in suppression of fraud are to be construed liberally for that purpose.

A conveyance made with a power of revocation is fraudulent as against a purchaser, though the power be future, or to be exercised with the assent of another person. So if the power be afterwards extinguished by fine, to defraud a purchaser, the fine is void as to him.

A bond void in part by the statute law, is void *in toto.*

None but *bona fide* purchasers for a valuable and not inadequate consideration, can take advantage of the stat. 27 Eliz. c. 4.

In an information (A) by Coke, the Queen's Attorney General, against Twyne of Hampshire, in the Star-Chamber, for making and publishing of a fraudulent gift of goods: the case on the stat. of 13 Eliz. cap. 5. (B) was such; Pierce was indebted to

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(A) That if a man be party or privy to a fraudulent grant, &c. an information lies against him upon the statute 13 Eliz. c. 5.; or an action of debt for so much as is the value of the goods, Dyer, 351 b. Com. Dig. Covin, B. 2. But although the statute subjects the parties to the frauds which it provides against, to certain penalties, and therefore, it should seem, ought to be construed strictly, yet Lord Mansfield, in *Cadogan* v. *Kennett*, Cowp. 434., observed, "that the statutes of 13 and 27 Eliz. cannot receive too liberal a construction, or be too much extended, in suppression of fraud." On the construction of these statutes in general, see the next note. (ED.)

(B) By the statute 13 Eliz. c. 5. s. 2. (made perpetual by statute 29 Eliz. c. 5.) for the avoiding of feigned, covinous, and fraudulent feoffments, gifts, grants, alienations, conveyances, bonds, suits, judgments, executions, &c. devised to the intent to delay, hinder, or defraud, creditors and others of their just and lawful actions, &c. it is enacted, "that all and every feoffment, gift, grant, alienation, &c. and all and every bond, suit, judgment, and execution, for any intent or purpose before declared, shall be utterly void:" with a proviso that the Act shall not extend to any grants, &c. upon good consideration and *bonâ fide.* In the construction of this statute it appears to have been at first held that all voluntary conveyances, that is, all conveyances not founded on a pecuniary or other valuable consideration, were fraudulent and void against actual or future creditors, see *Apharry* v. *Bodingham*, Cro. Eliz. 350. *Stiles* v. *Attorney General*, 2 Atk. 152. 1 Ves. & B. 112.; but it was soon settled, that the statute only extended to voluntary conveyances, where the grantor was indebted at the time, or where the deed was also fraudulent, 2 Vern. 327. 1 Ch. Ca. 99. 291. 1 Vent. 194. 1 Mod. 119. 1 Atk. 15. If there be, says Lord Hardwicke, a voluntary conveyance of real estate or chattel interest by one not indebted at the time, though he afterwards becomes indebted, if that voluntary conveyance was for a child, and no particular evidence or badge of fraud to deceive or defraud subsequent creditors, Twyne in four hundred pounds, and was indebted also to C. in two hundred pounds. C. brought an action of debt against Pierce, and pending the writ, Pierce being possessed of goods and chattels of the value of three hundred pounds, in secret made a general deed of gift of all his goods and chattels real and personal whatsoever to Twyne, in satisfaction of his debt; notwithstanding that Pierce continued in possession of the said goods, and some of them he sold; and he shore the sheep, and marked them with his own mark: and afterwards C. had judgment against Pierce, and had a *fieri facias* directed to the Sheriff of Southampton, who by force of the said writ came to make execution of the said goods; but divers persons, by the command of the said

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that will be good; but if any mark or fraud, collusion, or intent to deceive subsequent creditors appear, that will make it void, *Townsend* v. *Wyndham*, 2 Vez. 11, and see *Holcroft's case*, Dyer, 294 b. *Walker* v. *Burrows*, 1 Atk. 94. *Stephen* v. *Olive*, 2 Bro. C. C. 9. *Stileman* v. *Ashdown*, 2 Atk. 481. *Doe* v. *Routledge*, Cowp. 711. *Lush* v. *Wilkinson*, 5 Ves. 384. *Kidney* v. *Coussmaker*, 12 Ves. 155. *Jones* v. *Bolton*, 1 Cox, 288. *Holloway* v. *Millard*, 1 Madd. Rep. 414. *Battersbee* v. *Farringdon*, 1 Swanst. 106. 1 Wils. Ch. Rep. 88. In all cases the question of fraud must be decided by reference to the motives of the party making the deed or assignment. *Nunn* v. *Willsmore*, 8 T. R. 521. The grantor being indebted is not the only badge of fraud, but several other circumstances may also afford a strong presumption of the transaction being *mala fide*, *infra*; a secret transfer is always a badge of fraud, *Mace* v. *Cammell*, Lofft. 782.; so if the conveyance contain a power of revocation, or a power to mortgage, or if the grantor be allowed to continue in possession, the conveyance being absolute (*Stone* v. *Grubham*, 2 Bulst. 218., but see *infra* p. 81 a. n. (C).), it will be considered as fraudulent against creditors, *Tarback* v. *Marbury*, 2 Vern. 510.; so if the assignment be of the whole or greater part of the grantor's property (*infra*, *Estwick* v. *Calland*, 5 T. R. 420. Anst. 381.), or for a consideration clearly inadequate, it will be presumed to be fraudulent, *Matthews* v. *Feaver*, 1 Cox, 278., and see Rob. Conv. ch. 5. s. 3. If the transaction be not *bonâ fide*, the circumstance of its being even for a valuable consideration, will not alone take it out of the statute, *infra*, *Cadogan* v. *Kennett*, Cowp. 434. *Stileman* v. *Ashdown*, 2 Atk. 477. But an assignment by a debtor of his whole estate, in trust for all his creditors, in certain proportions, is valid, *Ingliss* v. *Grant*, 5 T. R. 530; and a creditor, unless prohibited by the bankrupt laws (see *ante* ii. p. 25 a, n. (B).), may give a preference to a particular creditor, or set of creditors, by a direct payment or assignment, if he does so in payment of his or their just demands, and not as a mere cloak to secure the property to himself, *Holbird* v. *Anderson*, 5 T. R. 235. *Estwick* v. *Calland*, *sup.*; and what he may do directly, may be done through the intervention of a trustee, *Nunn* v. *Wilsmore*, 8 T. R. 521. The pendency of another creditor's suit is immaterial; and the transaction is valid, though done to defeat that creditor's claim, *Pickstock* v. *Lyster*, 3 Maule and S. 371.; neither is it of any consequence that the fact of the assignment was unknown to, and therefore unacquiesced in by any of the creditors at the time; for the act itself being laudable, that determined its nature; and the motive was immaterial, S. C., and see *Meux* v. *Howell*, 4 East, 1. No person can take advantage of this statute but the creditors themselves; and therefore where A. made a fraudulent gift of his goods to B. and then died; B. brought an action against A.'s administrator for the goods, and the Court held he could not plead the statute, or maintain the possession of the goods, even to satisfy creditors; but the creditors may charge the vendee as executor *de son tort*, *Hawes* v. *Leader*, Cro. Jac. 270. Bull. N. P. 258., and see *post* p. 82 a. and n. (Q). *ib.* That copyholds, if not by custom subject to debts, are not within the statute, *Matthews* v. *Feaver*, 1 Cox, 278. 1 Evan Stat. 392. c. 8.; so of choses in action and money in the funds, *Dundas* v. *Dutens*, 1 Ves. jun. 198. *Nantes* v. *Carrock*, 9 Ves. 189. *Rider* v. *Kidder*, 10 Ves. 368.; but though a voluntary settlement of stock cannot be impeached during the settlor's life; his creditors, after his death, may sue the persons claiming under the settlement as executors *de son tort*, *Hawes* v. *Leader*, Cro. Jac. 271. *Edwards* v. *Harben*, 2 T. R. 587. *Stamford case*, 2 Leon. 223. Shep. Touch. 66. ed. Ather. As to assignments, where the debtor continues in possession, and as to settlements made after marriage, *infra* n. (C). (R). On the construction of the statute 27 Eliz. c. 4., see n. (R). *infra*. (ED.)

Twyne, did with force resist the said sheriff, claiming them to be the goods of the said Twyne by force of the said gift; and openly declared by the commandment of Twyne, that it was a good gift, and made on a good and lawful consideration. And whether this gift on the whole matter, was fraudulent and of no effect by the said Act of (a) 13 Eliz. or not, was the question. And it was resolved by Sir Thomas Egerton, Lord Keeper of the Great Seal, and by the Chief Justice Popham and Anderson, and the whole Court of Star Chamber, that this gift was fraudulent, within the statute of 13 Eliz. And in this case divers points were resolved:

1st. That this gift had the signs and marks of fraud, **[81 a]** because the gift is general, without exception of his (a) apparel, or any thing of necessity; for it is commonly said, *quod (b) dolus versatur in generalibus.*

2nd. The donor continued in possession (C), and used them as his own; and by

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(a) 5 Co. 60 a. b. 6 Co. 18 b. 10 Co. 56 b. 3 Inst. 152. Co. Lit. 3 b. 76 a. 290 a. b. 13 El. c. 5. 2 Leon. 8, 9. 47. 223. 308, 309. 3 Leon. 57. Latch. 222. 2 Rol. Rep. 493. Palm. 415. Cr. El. 233, 234. 645. 810. Cro. Jac. 270, 271. Dy. 295. pl. 17. 251. pl. 23. 2 Bulst. 226. Rastal. Entries 207 b. Lane 47. 103. Hob. 72. 166. Moor, 638. Doct. pla. 200. Yelv. 196, 197. 1 Brownl. 111. Co. Ent. 162 a. [1 Ld. Raym. 286. 1 Dav. 87. 296. 1 Burr. 467. 2 Cowp. 433, 631. 708. 712. 1 Ves. sen. 350. 2 T. R. 463. 591. 4 T. R. 51. 5 T. R. 237. 422. 424. 7 T. R. 70, 71, 72. 4 East, 13. 6 East, 265. 267, 8, 9. 273. 15 East, 25. 3 Taunt. 258. 5 Taunt. 218. 7 Taunt. 151. 2 Marsh. 428. 1 Moore C. P. Rep. 193. 5 Ves. 870. 10 Ves. 145. 11 Ves. 7. 17 Ves. 197. 1 Eden, 168. 1 Inst. ii. 237. (O). Shep. Touch. 66. 2 Bl. Com. 441. Bull. N. P. 257, 258 a. 1 Fonbl. Tr. Eq. 272, 273. 4 Cru. Dig. 2nd edit. 517. 6 Bart. Prec. 220 n. 2 Tidd. Pract. 6th edit. 1041. 1043. 1 Madd. Ch. 278. Vin. Abr. Fraud C. pl. 2. 9. Com. Dig. Covin B. 2. Bac. Abr. Fraud C. iii. 310, 311.]

(a) Godb. 398. [1 Burr. 478. 2 Burr. 827. 4 Burr. 2235. 1 Mont. B. L. 41. Vin. Abr. Grants pl. 4. Bac. Abr. Fraud C. iii. 312.]

(b) 2 Bulstr. 226. 2 Co. 34 a. 1 Rol. Rep. 157. Moor, 321. 1 Mont. B. L. 41.

(C) That permitting the former proprietor to continue in possession will in general make a sale of personal property fraudulent against creditors, acc. 1 Vez. 348. 1 Atk. 16. 162. 165. 1 Bro. C. C. 99. 1 Eq. Abr. Creditor and Debtor, E. pl. 2. *Hall* v. *Gurney*, 2 T. R. 587. 2 Bulst. 226. Cowp. 434. 1 Burr. 467. 484. 2 Burr. 831. Dougl. 303. 2 T. R. 587. 4 T. R. 51. 5 T. R. 237. 422. 424. 587. 7 T. R. 70, 71, 72. 4 East, 13. 5 East, 25. *Dewer* v. *Baynton, Bart.* 6 East, 257. 2 Bos. & P. 60. 5 Esp. 22. 1 Camp. 332. 5 Taunt. 212. 17 Ves. 197. 1 Mont. B. L. 41. But the donor continuing in possession is not in all cases a mark of fraud; as where a donee lends his donor money to buy goods; and at the same time takes a bill of sale of them for securing the money, Bull. N. P. 258., cited acc. *Kidd* v. *Rawlinson*, 2 Bos. and P. 59. *Benton* v. *Thornhill*, 2 Marsh. 429. *Tezeph* v. *Ingram*, 1 Moore, C. P. 195., and see *Meggot* v. *Mills*, 1 Ld. Raym. 286. *Leonard* v. *Baker*, 1 Maule & S. 251. *Reed* v. *Blades*, 5 Taunt. 212. So permitting the vendor to continue in possession does not avoid a sale of goods made *boná fide*, and in the ordinary course of dealing, *Kidd* v. *Rawlinson, sup. Watkins* v. *Birch*, 4 Taunt. 823.; at least where the sale is notorious to the neighbourhood, and the permission is given to accommodate the vendor, *Leonard* v. *Baker*, 1 Maule and S. 251. *Mair* v. *Glennie*, 4 Maule and S. 248; and the mere occurrence of any interval of time between the execution of the deed and the taking of possession under it, does not seem sufficient to taint the transaction with fraud, see *Jones* v. *Dwyer*, 15 East, 21. I Evan. Stat. 395. And though the sale of assignment is not in the ordinary course of dealing, yet if it be for valuable consideration, and the vendor's possession be inconsistent with the terms of the contract, it is valid; as where the sale is conditional, and possession is not to be taken until after a time, or the happening of an event, *Eastwick* v. *Cailland*, 5 T. R. R. 420. *Manton* v. *Moore*, 7 T. R. 67. So where A. being indebted, by settlement before marriage, in consideration of the marriage, and of ten thousand pounds, his wife's portion, which was supposed to be more than the amount of his debts at that time, conveyed all his real estate, and likewise his household goods to trustees in strict settlement, and after the marriage continued in possession of the goods, after which a creditor at the time of the settle-reason thereof he traded and trafficked (†) with others, and defrauded and deceived them.

3rd. It was made in secret, *et dona clandestina sunt semper suspiciosa* (D).

4th. It was made pending the writ (E).

5th. Here was a trust between the parties, for the donor possessed all, and used them as his proper goods (F), and fraud is always apparelled and clad with a trust, and a trust is the cover of fraud.

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ment, having obtained judgment, took them in execution, it was held, that the settlement was good against creditors. And see *Dewey* v. *Baynton*, 6 East 257. *Lady Arundel* v. *Phips*, 10 Ves. 139. So where some cows were made subjects of a marriage settlement, they were held not liable to the husband's debts, *Haselinton* v. *Gill*, cit. 2 T. R. 597.; but in a full report of S. C. in 3 T. R. 620. n. Lord Mansfield said, that the Courts had gone every length to protect the personal property of the wife, in cases clear of fraud, where trustees were interposed *before* marriage, but where the conveyance is made after marriage, it is void against creditors at the time; unless the portion is paid at the time, or where the settlement is made after marriage, in consideration of a portion paid before, as in *White* v. *Thornborough*, Bull. N. P. 259. See the cases cited in n. (B). *sup.* *Infra* p. 82 b. n. (R). In the case of a deed of separation between husband and wife, whereby the husband conveyed to trustees all his debts and effects, the greater portion of which were brought to him by the wife, in consideration of two hundred pounds (which bore but a small proportion to their value), to be paid to him by one of the trustees, in trust to sell, reimburse the trustee the sum advanced, pay the husband's debts which the trustees should consider justly due, and hold the residue for the wife; it was held that the motives of the transaction being *bona fide*, the assignment was valid against creditors, *Nunn* v. *Wilsmore*, 8 T. R. 521. So where A., a farmer, executed a bill of sale, on the 26th of September, of all his property, absolutely to B. for a debt of six hundred pounds, B. put his son in possession, A. continuing to reside on the premises, and to conduct the farm. On the 30th of November, the sheriff took the stock, corn, &c. in execution, at the suit of C. against A. After satisfying the execution, enough remained to cover the six hundred pounds due to B.; it was held that the jury, allowing for the fluctuation of the market, were warranted in finding that the goods, at the time of executing the bill of sale, were not worth more than the six hundred pounds; and therefore that the bill of sale was made *bonâ fide*, and that A. was entitled to recover to the amount of six hundred pounds in an action of trover against the sheriff, *Benton* v. *Thornhill*, 2 Marsh. 427. 7 Taunt. 149. So where the property and goods of A. being in possession of the sheriff under a writ of *fieri facias*, he executed a deed of assignment to B. for a valuable consideration, on which the execution was withdrawn; B. superintended the management of the property, but allowed A. to continue in possession; and the same property was seized under a subsequent execution, at the suit of C., it was held that such property was protected by the assignment to B., although A. had continued in the visible possession, *Joseph* v. *Ingram*, 1 Moore, 189. So the actual delivery of the goods may be dispensed with, when the nature of the subject renders it impracticable, or when acts equivalent have taken place; as in the case of bulky goods, the delivery of the key of the warehouse, or in case of assignment of a ship, or cargo at sea, the paper documents being delivered over, see *ante* ii. p. 25 b. and cases there cited with reference to the bankrupt laws. And in conveyances of land, where the consideration is future, the donor's continuing in possession, it seems, is not fraudulent, unless it be expressly proved that fraud was intended, *Stone* v. *Grubham*, 1 Roll. Rep. 3. But the possession of personal chattels must be delivered, although the grant or conveyance include real property or chattels real. *Worsley* v. *Demattos*, 1 Burr. 467. *Law* v. *Skinner*, 2 Bl. Rep. 996. (ED.)

(†) [1 Evan. Statute 394. Shep. Touch. ed. Ather. 64. Com. Dig. Covin. B. 2 Bac. Abr. Fraud C. iii. 311. and see the books cited in n. (C). *infra.*]

(D) See *ante* p. 80 b. n. (B). *Post* 6 Co. 72 a. *Wilson* v. *Day*, 2 Burr. 827. *Jacob* v. *Shepherd*, 1 Burr. 478. 1 Mont. B. L. 41. Shep. Touch. ed. Ather. 64. Com. Dig. Covin, B. 2. (ED.)

(E) See *ante* p. 80 b. n. (B). Com. Dig. Covin, B. 2. (ED.)

(F) See Com. Dig. Covin, B. 2. *Post* 11 Co. 74 a. *Tarback* v. *Marbury*, 2 Vern. 510. *Pickstock* v. *Lyster*, 3 Maule and S. 371. (ED.)

6th. (†) The deed contains, that the gift was made honestly, truly, and *bona fide: et clausulæ inconsuet' semper inducunt suspicionem.*

Secondly, it was resolved, that notwithstanding here was a true debt due to Twyne, and a good consideration of the gift, yet it was not within the proviso of the said Act of 13 Eliz. by which (‡) it is provided, that the said Act shall not extend to any estate or interest in lands, &c. goods or chattels made on a good consideration and *bona fide;* for although it is on a true and good consideration, yet it is not *bona fide*, for no gift shall be deemed to be *bona fide* within the said proviso which is accompanied with any trust; as (§) if a man be indebted to five several persons, in the several sums of twenty pounds, and hath goods of the value of twenty pounds, and makes a gift of all his goods to one of them in satisfaction of his debt, but there is a trust between them, that the donee shall deal (*c*) favourably with him in regard of his poor estate, either to permit the donor, or some other for him, or for his benefit, to use or have possession of them, and is contented that he shall pay him his debt when he is able; this shall not be called *bona fide* within the said proviso; for the proviso saith on a good consideration, and *bona fide;* so a good (†) consideration doth not suffice, if it be not also *bona fide* (G): and therefore, reader, when any gift shall be to you in satisfaction of a debt, by one who is indebted to others also; 1st, Let it be made in a public manner, and before the neighbours, and not in private, for secrecy is a mark of fraud. 2nd, Let the goods and chattels be appraised (‡) by good people to the very value, and take a gift in particular in satisfaction of your debt. 3rd, Immediately after the gift, take the possession of them; for continuance of the possession in the donor, is a sign of trust. And know, reader, that the said words of the proviso, on a good consideration, and *bona fide*, do not extend to every gift made *bona fide;* and therefore there are two manners (§) of gifts on a good consideration, *scil.* consideration of nature or blood, and a valuable consideration (H). As to the first, in the case before put; (||) if he who is indebted to five several persons, to each party in twenty pounds, in consideration of natural affection, gives [81 b] all his goods to his son, or cousin, in that case, forasmuch as others should lose their debts, &c. which are things of value, the intent of the Act was, that the consideration in such case should be valuable; for equity requires, that such gift, which defeats others, should be made on as high and good consideration as the things which are thereby defeated are; and it is to be presumed, that the father, if he had not been indebted to others, would not have dispossessed himself of all his goods, and subjected himself to his cradle; and therefore it shall be intended, that it was made to defeat his creditors (I): and if consideration of nature or blood should be a good consideration within this proviso, the statute would serve for little or nothing, and no creditor would be sure of his debt. And as to gifts made *bona fide*, it is to be known, that every gift made *bona fide*, either is on a trust between the parties, or without any

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(†) [Com. Dig. Covin B 2.]

(‡) [Shep. Touch. 65. 1 Tr. Eq. 272. Moor, 639.]

(§) [Vin. Abr. Fraud F. pl. 6. 13. Com. Dig. Covin B. 2. Bac. Abr. Fraud C. iii. 310.]

(*c*) Goldsb. 161.

(†) *Vide ante* 36 a. b. [2 Bulst. 218. 1 Atk. 168. 1 Ves. 348. 2 T. R. 591. 3 T. R. 618.]

(G) See acc. *ante* p. 80 b. n. (B). and the cases there cited. (ED.)

(‡) [6 East, 265. 269. 3 Wood, 1. Bull. N. P. 258. Vin. Abr. Fraud F. pl. 7.]

(§) [2 Bl. Com. 444. Dyer 336 b. 2 Bulst. 125. Bac. Abr. Agreement B. 2.]

(H) See 2 Bl. Com. 297. 1 Fonbl. Tr. Eq. 271 n. 2 Fonbl. 26. *Ante* i. p. 121 b. n. (P). (ED.)

(||) Cr. Jac. 127. Palm. 214. [1 Mod. 119. 5 T. R. 237. Com. Dig. Dig. Covin B. 2. Bac. Abr. Fraud C. iii. 310.]

(I) See acc. *Apharry* v. *Bodingham*, Cro. Eliz. 350. *Fitzer* v. *Fitzer*, 2 Atk. 512. *Taylor* v. *Jones*, 2 Atk. 600. Eq. Ca. Abr. 148. 1 Fonbl. Tr. Eq. 5th edit. 271, 2. and the books cited *ante* p. 80 b. n. (B). (ED.)

trust; every gift made on a trust is out of this proviso (K); for that which is betwixt the donor and donee, called (*a*) a trust *per nomen speciosum*, is in truth, as to all the creditors, a fraud, for they are thereby defeated and defrauded of their true and due debts. And every trust is either expressed, or implied: an express trust is, when in the gift, or upon the gift, the trust by word or writing is expressed: a trust implied is, when a man makes a gift without any consideration, or on a consideration of nature, or blood only: and therefore, if a man before the stat. of 27 H. 8. had bargained his land for a valuable consideration to one and his heirs, by which he was seised to the use of the bargainee; and afterwards the bargainor, without a consideration, infeoffed others, who had no notice of the said bargain; in this case the law implies a trust and confidence, and they shall be seised to the (†) use of the bargainee: so in the same case, if the feoffees, in consideration of nature, or bloode had without a valuable consideration enfeoffed their sons, or any of their blood who, had no notice of the first bargain, yet that shall not toll the use raised on a valuable consideration (L); for a feoffment made only on consideration of nature or blood, shall not toll an use raised (‡) on a valuable consideration but shall toll an use raised on consideration of nature, for both considerations are *in æquali jure*, and of one and the same nature (M).

And (§) when a man, being greatly indebted to sundry persons, makes a gift to his son, or any of his blood, without consideration, but only of nature, the law intends a trust betwixt them, *scil.* that the donee would, in consideration of such gift being voluntarily and freely made to him, and also in consideration of nature, relieve his father, or cousin, and not see him want who had made such gift to him, *vide* 33 H. 6. 33. (‖) by Prisot, if the father enfeoffs his son and heir apparent within age *bona fide*, yet the lord shall have the wardship of him (N): so note, valuable consideration is a good consideration within this proviso; and a gift made *bona fide* is a gift made without any trust either expressed or implied: [82 a] by which it appears, that as a gift made on a good consideration, if it be not also *bona fide* (O), is not within the proviso; so a gift made *bona fide*, if it be not on a good consideration, is not within the proviso; but it ought to be on a good consideration, and also *bona fide*.

To one who marvelled what should be the reason that Acts and statutes are continually made at every Parliament without intermission, and without end; a wise man made a good and short answer, both which are well composed in verse.

Quæritur, ut crescunt tot magna volumina legis?
In promptu causa est, crescit in orbe dolus.

And because fraud and deceit abound in these days more than in former times, it was resolved in this case by the whole Court, that all statutes made against fraud

(K) *I.e.* a trust in favour of the grantor. See *ante* p. 80 b. n. (B). and the cases there cited, 1 Cowp. 233. 5 T. R. 422. 8 T. R. 521. Vin. Abr. Fraud F.—pl. 6. (ED.)

(*a*) 6 Co. 72 b. [See n. (K). *infra.*]

(†) 2 Rol. 799. [1 Fearne 476. Sugd. Gilb. Uses 15. 371 n. Vin. Abr. Uses A. pl. 1. Com. Dig. Covin B. 2. Uses D. 2.]

(L) S. P. *Chudleigh's case*, 1 Co. 122 b. i. p. 302. Plowd. 351. *Brown's case*, Dyer, 12 b. pl. 55. Bro. Feoffment at Uses, pl. 50. Gilb. Uses, 173. 3rd edit. 371. Bac. Law Tracts, 312. 1 Fearne, 477. Vin. Abr. Uses A. pl. 3. Com. Dig. Uses D. 2. (ED.)

(‡) 2 Rol. 779.

(M) S. P. Vin. Abr. Uses A. pl. 2. Com. Dig. Uses D. 2. Gilb. Us. 173. 3rd edit. 371. At this day, however, it is clear that a conveyance by a trustee, for a good consideration, would not prevail over the first *cestui que trust*, although merely a volunteer. *Id. ibid.* (ED.)

(§) [Com. Dig. Covin B. 2.]

(‖) 33 H. 6. 16. 7 Co. 39 b.

(N) That wardships in chivalry are now gone, by the statute 12 Cha. 2. c. 24, *ante* i. p. 45 b. n. (P 3). (ED.)

(O) See *ante* p. 80 b. n. (B). *Infra* n. (R). 6 East, 267. 5 Ves. 870. (ED.)

should be liberally and beneficially expounded to suppress the fraud (P). Note, reader, according to their opinions, divers resolutions have been made.

Between Pauncefoot and Blunt, in the Exchequer Chamber, Mich. 35 & 36 El. the case was: Pauncefoot being indicted for recusancy, for not coming to divine service, and having an intent to flee beyond sea, and to defeat the Queen of all that might accrue to her for his recusancy or flight, made a gift of all his leases and goods of great value, coloured with feigned consideration, and afterwards he fled beyond sea, and afterwards was outlawed on the same indictment: and whether this gift should be void to defeat the Queen of her forfeiture, either by the common law, or by any statute, was the question: and some conceived, that the common law, which (*a*) abhors all fraud, would make void this gift as to the Queen, *vide* Mich. 12 & 13 El. Dyer (*b*) 295. 4 & 5 P. & M. 160. And the stat. of (*c*) 50 E. 3. cap. 6. was considered; but that extends only in relief of creditors, and extends only to such debtors as flee to sanctuaries, or other privileged places: but some conceived, that the stat. of (*d*) 3 H. 7. cap. 4. extends to this case. For although the preamble speaks only of creditors; yet it is provided by the body of the Act generally, that all gifts of goods and chattels made or to be made on trust to the use of the donor, shall be void and of no effect, but that is to be intended as to all strangers who are to have prejudice by such gift, but between the parties themselves it stands good: but it was resolved by all the Barons, that the stat. 13 Eliz. c. 5. (*e*) extends to it, for thereby it is enacted and declared, that all feoffments, gifts, grants, &c. "to delay, hinder or defraud creditors, and others, of their just and lawful actions, suits, debts, accounts, damages, penalties, forfeitures, heriots, mortuaries and reliefs," shall be void, &c. So that this Act doth not extend only to creditors, but to all others who had cause of action, or suit, or any penalty, or forfeiture, &c. (Q).

[82 b] And it was resolved, (†) that this word "forfeiture" should not be intended only of a forfeiture of an obligation, recognizance, or such like (as it was objected by some, that it should, in respect that it comes after damage and penalty) but also to

(P) See acc. *Magdalen College case, post* 11 Co. 66. *Cadogan* v. *Kennett*, Cowp. 434., cited *ante* p. 80 b. n. (A). *Infra* n. (R). Shep Touch. 66. ed. Ather. (ED.)

(*a*) *Ante* 78 a.

(*b*) *Ante* 78 a. b. Dyer 295. pl. 8, 9, 10, &c. Lane 44.

(*c*) Co. Lit. 76 a. [1 Fonbl. Tr. Eq. 276 n.]

(*d*) Cro. El. 291, 292. Lane, 45. [1 Fonbl. Tr. Eq. 5th edit. 276 n.]

(*e*) Co. Lit. 3 b. 76 a. 290 a. b. 3 Inst. 152. 5 Co. 60 a. b. 6 Co. 18 b. 10 Co. 56 b. Co. Ent. 162 a. 1 Leon. 47. 308, 309. 2 Leon. 8, 9. 223. 3 Leon. 57. Latch. 222. 2 Rol. Rep. 493. Palm. 415. Cr. El. 233, 234. 645. 810. Cr. Jac. 270. 2 Bulst. 226. Hob. 72. 166. Yelv. 196, 197. 1 Brownl. 11. Dyer 295. pl. 17. 351. pl. 23. Rastal Fraudulent Deeds. 1 Rast. Ent. 207 b. Lane, 47. 103. Moor, 638. Doct. pl. 200. [Shep. Touch. 66. ed. Ather. 1 Fonbl. Tr. Eq. 279. Com. Dig. Covin B. 2. Bac. Abr. Outlawry D. 2. 2. V. 227.]

(Q) See *ante* p. 80 b. n. (B). A wife claiming under a covenant to make a provision in case of her surviving, is a sufficient creditor within the 13 Eliz. *Rider* v. *Kidder*, 10 Ves. 360. In *Luckner* v. *Freeman*, Prec. Ch. 105. a distinction appears to have been taken between the claims of real creditors and a debt founded *in maleficio*: for A. having brought an action against B. for lying with his wife, B. assigned his estates to trustees in trust to pay the several debts mentioned in a schedule, and such other debts as he should name. A. recovered five thousand pounds damages, and brought his bill to set aside this deed, as fraudulent; but the Court held that it was not fraudulent, either in law or equity; for that the plaintiff was no creditor at the making of the deed; and though it were made with an intent to prefer his real creditors before this debt, when it came afterwards to be a debt, yet it was a debt founded only *in maleficio*, and therefore it was conscientious in him to prefer the other debts before it. But the plaintiff was held to have an interest in the surplus, after payment of the other debts, 1 Fonbl. Tr. Eq. 5th edit. 278, 9. As to the effect of fraudulent transactions to deceive the Crown of forfeitures, &c. see Rob. Conv. ch. 5. s. 3. (ED.)

(†) [Com. Dig. Covin B. 2.]

every thing which shall by law be forfeited to the King or subject. And therefore if a man, to prevent a forfeiture for felony, or by outlawry makes a gift of all his goods, and afterwards is attainted or outlawed, these goods are (*a*) forfeited notwithstanding this gift: the same law of recusants, and so the statute is expounded beneficially to suppress fraud. Note well this word (*b*) "declare" in the Act of 13 Eliz. by which the Parliament expounded, that this was the (*c*) common law before. And according to this resolution it was decreed, Hil. 36 Eliz. in the Exchequer Chamber.

Mich. 42 & 43 Eliz. in the Common Pleas, on evidence to a jury, between Standen (*d*) and Bullock, these points were resolved by the whole Court on the stat. of 27 El. c. 4. (R) Walmsley J. said, that Sir Christopher Wray, late C. J. of England, reported

(*a*) Co. Lit. 290 b.

(*b*) Co. Lit. 76 a. 290 b.

(*c*) Hard. 397. [1 Burr. 85. Shep. Touch. 66. ed. Ather. 1 Evan. Stat. 382, 383.

(*d*) Moor. 605. 615. Bridgm. 23. 5 Co. 60 b. Palm. 217. Lane, 22. 2 Jones 95. [1 Inst. ii. 238. (O). Bull. N. P. 260. 4 Cru. Dig. 525. Sugd. Pow. 2nd edit. 410, 411. Sugd. Vend. 574, 575. Vin. Abr. Fraud L. pl. 2. 5. Com. Dig. Covin B. 3.]

(R) By the statute 27 Eliz. c. 4., made perpetual by the 30 Eliz. c. 18. s. 3., it is enacted, that all conveyances, grants, &c. out of any lands, tenements, or other hereditaments, *for the intent and of purpose to defraud and deceive* such persons as shall purchase the same lands, tenements, or hereditaments, so formerly conveyed, granted, &c. or any rent, profit, or commodity, in or out of the same, shall be deemed and taken only as against such persons, and their representatives as should so purchase for money or other good considerations the same lands, tenements, or other hereditaments, or any rent, profit, or commodity, in or out of the same, to be utterly void. The fourth section expressly excepts conveyances made upon good consideration, and *bona fide*. And the statute also enacts, that if any person shall make any conveyance, &c. of any lands, tenements, or hereditaments, with any clause of revocation or alteration at his pleasure of such conveyance, &c. and shall afterwards sell the same to any person or persons for money or other good consideration paid or given (the said first conveyance, &c. not being revoked according to the power reserved by the said *secret* conveyance, &c.), then the said first conveyance, &c. as touching the lands, tenements, and hereditaments, so after sold, against the vendees, &c. shall be deemed and be void, and of none effect. Provided that no *bona fide* mortgage should be affected by the Act. On the construction of this statute, it has been held that every voluntary conveyance shall be presumed to be fraudulent against a subsequent purchaser, *Bovey's case*, 1 Ventr. 194. *Douglas* v. *Ward*, 1 Ch. Ca. 100. *Holford* v. *Holford*, 1 Ch. Ca. 217. *Colville* v. *Parker*, Cro. Jac. 158. *Evelyn* v. *Templar*, 2 Bro. C. C. 148. And to bring a case within this statute, it is not necessary that the person who sells the land, should make the former conveyance, *Burrell's case*, *post* Co. 72., and see 1 Evan. Stat. 392. Shep. Touch. ed. Ather. 64.; and although the subsequent purchaser should have notice of the preceding conveyance, yet he will be allowed to invalidate it, *post* 5 Co. 60 b. Cowp. 711. *Doe d. Otley* v. *Manning*, 9 East, 59. *Hill* v. *The Bishop of Exeter*, 2 Taunt. 69. *Pulvertoft* v. *Pulvertoft*, 18 Ves. 84. *Metcalfe* v. *Pulvertoft*, 1 Ves. and B. 183, 4. *Buckle* v. *Mitchell*, 18 Ves. 100. And the statute being general, and made to suppress fraud, extends to fraudulent conveyances to the King, *Magdalen College case*, *post* 11 Co. 66. A conveyance for payment of debts generally, to which no creditor is party, nor any particular debts expressed, is a fraudulent conveyance within this statute, against a subsequent purchaser for a valuable consideration, *Leech* v. *Leech*, 1 Ch. Ca. 249.; though if made with an honest intent, and the purchaser had notice of the trust, it seems that he will not be relieved against it, see *Langton* v. *Tracey*, 2 Ch. Rep. 16. *Stevenson* v. *Hayward*, Prec. Ch. 310. Rob. Conv. 335. Sugd. Vend. 554. It has also been determined that voluntary settlements, though for what is called meritorious consideration, upon a wife and children, are within the statute, and void against a subsequent purchaser for valuable consideration, with notice, whether by conveyance or articles, *Taylor* v. *Hill*, Chan. 1763. MS. *Evelyn* v. *Templar*, 2 Bro. C. C. 148, said to be incorrectly reported 18 Ves. 91. *Doe* v. *Martyr*, 1 N. R. 332.

to him, that he, and all his companions of the King's Bench were resolved, and so directed a jury on evidence before them; that where a man had conveyed his land to

Doe v. *Manning*, *sup.* *Doe* v. *Hopkins*, 9 East, 70. *Hill* v. *The Bishop of Exeter*, *sup.* *Buckle* v. *Mitchell*, *sup.* *Doe* v. *James*, 16 East, 212. And in such cases a Court of Equity will not restrain the husband, by injunction, from selling; neither can the purchase money be laid hold of in favour of claims under a previous settlement, void under the statute 27 Eliz. as being voluntary, 18 Ves. 91. A voluntary settlor cannot compel a specific performance of the contract against a purchaser, whether the latter bought with or without notice; for the settlement is binding on the settlor, and he has no right to disturb it, *Smith* v. *Garland*, 2 Mer. 123., and see *Johnson* v. *Legard*, 3 Madd. Rep. 283.; though it seems that a specific performance would be enforced in favour of the purchaser, even though he bought with notice, *Buckle* v. *Mitchell*, *sup.* With respect to what shall be deemed a fraudulent or voluntary settlement as against purchasers or creditors, under the 13 and 27 Eliz.—any conveyance executed by a husband merely in favour of his wife or children, after marriage (a marriage in Scotland is sufficient, *Ex parte Hall*, 18 Ves. 112), which rests wholly on the moral duty of a husband and parent to provide for his wife and issue, is voluntary, and void against purchasers (*Woodie's case*, cit. in *Colville* v. *Parker*, Cro. Jac. 158. *Goodright* v. *Moses*, 2 Bl. 1019. *Chapman* v. *Emery*, Cowp. 278. *Evelyn* v. *Templar*, *sup.* *Parker* v. *Serjeant*, Finch, 146. Sugd. Pow. 556), and against such persons as were creditors *at the time the settlement was made*, *Kidney* v. *Coussmaker*, 12 Ves. 155., and see *Middlecombe* v. *Marlow*, 2 Atk. 520. *White* v. *Sansom*, 3 Atk. 413.; unless it be a single debt (*Lush* v. *Wilkinson*, 5 Ves. 387.), or unless the debt be secured by mortgage, in which case it would not affect the settlement, *Stephens* v. *Olive*, 2 Bro. C. C. 30. But if such settlement contain a provision for debts (*George* v. *Millbanke*, 9 Ves. 104.), or is in pursuance of a bond (*Jason* v. *Jervis*, 1 Vern. 286.), or other agreement before marriage (*Beaumont* v. *Thorpe*, 1 Vez. 27. *Hylton* v. *Biscoe*, 2 Vez. 308. *Dundas* v. *Dutens*, 2 Cox, 236. 1 Ves. jun. 198. *Battersbee* v. *Farringdon and Others*, 1 Swanst. 106. 1 Wils. 88., *sed vid.* 1 Eden, 61.) or upon payment of money, as a portion (*Stileman* v. *Ashdown*, 2 Atk. 479. *Jones and Marsh*, For. 63. S. C. M. S. *Wheeler* v. *Caryl*, Ambl. 121. *Hilton* v. *Biscoe*, 2 Vez. 308. *Parsloe* v. *Weedon*, Eq. Ca. Abr. 149.), or a legacy of the wife, or other property in her right which could only be obtained by the assistance of a Court of Equity, (see *Wright* v. *Morley*, 11 Ves. 12. *Murray* v. *Lord Elibank*, 13 Ves. 1. Rob. Conv. ch. 3. sec. 10, 11, 12. Newland on Contracts, ch. 7. Roper on Rights of Married Women, &c.), or a new additional sum of money, or an agreement to pay money (provided the money be afterwards paid), this makes the settlement good, both at law and equity, against creditors as well as purchasers (*Browne* v. *Jones*, 1 Atk. 190. *Ex parte Hall*, 1 Ves. and B. 112. Prec. Ch. 101. 405.), provided there be no fraud, nor great inadequacy, *Ward* v. *Shallet*, 1 Vez. 18., and see *Jones* v. *Marsh*, For. 65. S. C. MS. *Matthews* v. *Feaver*, 1 Cox, 280. So where a husband, who had made no provision on his wife, agreed that her fortune, which was in trustees' hands, should be laid out in a purchase of lands; the agreement was not considered as voluntary, and impeachable by a creditor of the husband, *Moore* v. *Rycault*, Prec. Ch. 22. And where a husband, upon a separation between him and his wife settled real estate, to the amount of three hundred pounds per annum, on the wife, for her separate maintenance, and of the children of the marriage, the settlement was not deemed fraudulent under the 13 Eliz. *Hobbs* v. *Hall*, 1 Cox, 445. So where a wife joins with her husband in destroying the settlement made on her marriage, and a new settlement is made, such new settlement will be good, though a better provision is made for the wife and children than was contained in the original settlement, *Scott* v. *Bell*, 2 Lev. 70. *Brill* v. *Bumford*, Prec. Ch. 113. And it seems that the wife's joining in barring her dower for the benefit of her husband, will be a sufficient consideration for a settlement on her, *Lavender* v. *Blackstone*, 2 Lev. 146. *Evelyn* v. *Templar*, 2 Bro. C. C. 148. 18 Ves. 91. *Pulvertoft* v. *Pulvertoft*, 18 Ves. 84. So when a father is tenant for life, with remainder to the son in tail, the father's joining in the settlement by suffering a recovery will support the limitations against the creditors, *Russel* v. *Hammond*, 1 Atk. 13. Whether a settlement after marriage, in pursuance of a parol promise before, and proved only the subsequent acknowledgment of the party, the use of himself for life, and afterwards to the use of divers others of his blood, with a future power of revocation, as after such feast, or after the death of such one;

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is valid against creditors? see 1 Evan. Stat. 387. A settlement, before marriage, even of moveable effects by a person indebted at the time, will be good against creditors, *Cadogan* v. *Kennett*, Cowp. 432. *James* v. *Wollaton*, 3 T. R. 618. *Haselinton* v. *Gill*, 3 T. R. 620 n., *Battesbee* v. *Farringdon and Others*, 1 Swanst. 106. 1 Wils. 88.; nor is it necessary that the husband should receive a portion with his wife, *Browne* v. *Jones*, 1 Atk. 190.; and the fact of her knowing him to be indebted at the time is not material, *Wheeler* v. *Caryl*, Ambl. 121. *Nairn* v. *Prowse*, 6 Ves. 759. *Campion* v. *Cotton*, 17 Ves. 171. And if real estate form part of the settlement, and, after the marriage, the husband build on the land, or enfranchise copyholds included in the settlement, yet the creditors cannot have the benefit of these acts by way of charge against the wife, *Campion* v. *Cotton*, *sup.* So if a bond is given on marriage and receipt of a portion, conditioned to pay a sum beyond the marriage portion, in case of death or insolvency, such bond is good, so far as relates to the property received with the wife, but beyond that is fraudulent as against creditors, *Ex parte Meaghan*, 1 Sch. and Lef. 179. *Ex parte Murphy*, *id.* 144., overruling what is said by Lord Kenyon in *Staines* v. *Plank*, 8 T. R. 389. And a settlement by a widow on her children, previous to her second marriage, with her husband's consent, has been held good against a subsequent purchaser, *Newstead* v. *Searles*, 1 Atk. 265. *King* v. *Cotton*, 2 P. Wms. 674. Where a settlement is made after marriage, and there being creditors at the time, is on that account declared fraudulent, the property so settled becomes part of the assets, and all subsequent creditors are let in to partake of it, *Taylor* v. *Jones*, 2 Atk. 600. *Dundas* v. *Dutens*, 1 Ves. jun. 198. *Montague and Lord Sandwich*, 12 Ves. 156. n.; and in one case a subsequent creditor filed what is called a fishing bill, in order to prove debts antecedent to the settlement, and thus establish a fund for the payment of his own debt, *Lush* v. *Wilkinson*, 5 Ves. 384. *Kidney* v. *Coussmaker*, 12 Ves. 155, and see Shep. Touch. 66. ed. Ather. That a limitation in a marriage settlement to brothers, after other limitations to the use of the first and other sons of the settlor in tail male, is not valid against a purchaser for valuable consideration, *Johnson* v. *Legard*, 3 Madd. Rep. 283. But limitations in favour of the sons of a second marriage, interposed between limitations to the sons of the first marriage, and the daughters of such marriage, were held good; and a conveyance to a purchaser for valuable consideration, not valid against the issue of such second marriage, *Clayton* v. *Earl of Winton*, 3 Madd. 302. (*a*)., and see *Smith* v. *Garland*, 2 Mer. 123. *Sutton* v. *Chetwynd*, 3 Mer. 249.

To take advantage of the stat. 27 Eliz. a person must have purchased *bona fide*, and for a valuable consideration, though the Court will not enquire into the amount of the consideration, unless it was so small as to be palpably fraudulent, *Upton* v. *Bassett*, Cro. Eliz. 444. *Needham* v. *Beaumont*, *post* 3 Co. 83 b. 2 And. 233. *Doe* v. *Routledge*, Cowp. 705. *Bullock* v. *Sadler*, Ambl. 764. *Hill* v. *Bishop of Exeter*, 2 Taunt. 69. *Doe* v. *James*, 16 East, 212. *Metcalfe* v. *Pulvertoft*, 1 Ves. and B. 184. Sugd. Vend. 552. *Id.* Pow. 345. 1 Evan. Stat. 393. Marriage is held to be a sufficient consideration, *Douglas* v. *Ward*, 1 Ch. Ca. 99; but a conveyance to a man's children, or to his wife after-marriage by way of jointure, will not enable them to avoid a preceding conveyance, *Upton* v. *Bassett*, *sup.* Mortgagees and lessees, though at a rack-rent, are considered as purchasers within the statute, *Chapman* v. *Emery*, Cowp. 279. *Goodright* v. *Moses*, 2 Bl. Rep. 1019. *Shaw* v. *Standish*, 2 Vern. 327. *Cross Fausterditch*, Cro. Jac. 181.; but subject to the mortgage, or lease, the voluntary settlement will be good, *Rand* v. *Cartwright*, Nels. 101. Where, however, the price is very inadequate, as only a third part of the value, (*Metcalfe* v. *Pulvertoft*, 1 Ves. & B. 183, 184.), or there are other circumstances indicating a fraudulent collusion between the purchaser and the vendor, to avoid a preceding conveyance, a purchaser will not be entitled to the benefit of the Act, *Doe* v. *Routledge*, Cowp. 705. *Doe d. Parry* v. *James*, 16 East, 212. But the title of a subsequent purchaser for valuable consideration is not affected by an intermediate fraudulent conveyance of which he had no notice. *Doe d. Borhell* v. *Martyr*, 1 N. R. 332. The subject of the sale must be an existing lawful interest, 1 Inst. 3 b. ii. 236. *Hutton* v. *Jones*, Bul. N. P. 90. Sugd. Vend. 552.; but a grant and afterwards, and before the power of revocation began, he, for valuable consideration, bargained and sold the land to another and his heirs: this bargain and sale is within the (e) remedy of the said statute (S). For although the statute saith, "the said first conveyance not by him revoked, according to the power by him reserved," which seems by the literal sense to be intended of a present power of revocation, for no revocation can be made by force of a future power until it comes *in esse*: yet it was held that the intent of the Act was, that such voluntary conveyance which was originally subject to a power of revocation, be it *in præsenti* or *in futuro*, should not stand against a purchaser *bona fide* for a valuable consideration; and if other construc-

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in consideration of releasing an assertion of title is *prima facie* for value, *Hill* v. *The Bishop of Exeter*, 2 Taunt. 69.

The statute 27 Eliz. only affects real estate; and the 13 Eliz. which affects personal estate, is in favour of creditors, and does not extend to the case of a purchaser, *Daubeny* v. *Cockburn*, 1 Meriv. 635. *Sloane* v. *Cadogan*, Rolls. Dec. 1808. MS. Sugd. Vend. Appx. No. 24. And both these statutes only avoid voluntary conveyances as against creditors and subsequent purchasers; but they are binding on the party making the same, and all persons claiming under him as volunteers, *Hawes* v. *Leader*, Cro. Jac. 270. *Brookbank* v. *Brookbank*, 1 Eq. Ca. Abr. 168. *Rand* v. *Cartwright*, Nels. 101. 22 Vin. Abr. 18. *Franklin* v. *Thornbury*, 1 Vern. 132. *Villers* v. *Beaumont*, 1 Vern. 100. *Bale* v. *Newton*, 1 Vern. 464. *Lord Lincoln's case* cited in *Clavering* v. *Clavering*, 2 Vern. 475. *Sneed* v. *Culpeper*, 22 Vin. Abr. 24. pl. 3. *Williams* v. *Sawyer*, Sel. Ca. in Ch. 6. *Curtis* v. *Price*, 12 Ves. 103. *Pulvertoft* v. *Pulvertoft*, 18 Ves. 92. *Whalley* v. *Whalley*, 1 Meriv. 436. *Smith* v. *Garland*, 2 Meriv. 123. If there be two or more voluntary conveyances, the first shall prevail, unless the latter be for payment of debts, *Goodwyn* v. *Goodwyn*, 1 Ch. Rep. 92. 2 Ch. Rep. 199. And if a man makes a voluntary conveyance of land, and the alienee sells the same for a valuable consideration, the land is bound, *Sagittary* v. *Hyde*, 2 Vern. 44. *Prodgers* v. *Langham*, 1 Sid. 133. *Andrew Newport's case*, Skin. 423. S. C. nom. *Smartle* v. *Williams*, 3 Lev. 387. *Wilson* v. *Wormal*, Godb. 16. *Doe* v. *Martyr*, 1 N. R. 332. *Parr* v. *Eliason*, 1 East, 92.: which rule has been applied to persons having only equitable rights, *George* v. *Millbank*, 9 Ves. 190. 1 Mer. 638. So if a voluntary grantee gain credit by the conveyance to him, and a person is induced to marry him on account of such provision, the deed, though void in its creation as to purchasers, will, on the marriage being solemnized, no longer remain voluntary, but will be considered as made upon valuable consideration, *Prodgers* v. *Langham*, *sup.* 9 Ves. 133. *Brown* v. *Carter*, 5 Ves. 862. 9 Ves. 193. That parol evidence is admissible in support of a deed apparently voluntary, *Chapman* v. *Emery*, Cowp. 278.; and that copyholds are within the statute 27 Eliz. *Doe d. Watson* v. *Routledge*, Cowp. 705. (ED.)

(e) 1 Sid. 133. [Moor. 611. Bridg. 22. Cowp. 280. Shep. Touch. 64, 65. Sugd. Vend. 5th edit. 575. Sugd. Pow. 2nd edit. 410, 411. 4 Cru. Dig. 525, 526. 1 Evan. Stat. 394. Vin. Abr. Fraud L. pl. 2. 5. Com. Dig. Condition B. 3.]

(S) A general power of revocation in a settlement will make it void against a purchaser, although the power is only conditional, *Griffin* v. *Stanhope*, Cro. Jac. 454. *Lavender* v. *Blackstone*, 3 Kep. 526. *Infra.*; unless the condition be *bona fide*, as where the power of revocation is to be exercised with the consent of persons who are not under the control of the settlor, in which case the settlement will be valid against subsequent purchasers, *Leigh* v. *Winter*, 1 Jo. 411. Lane, 22. *Buller* v. *Waterhouse*, 2 Jo. 94. 3 Kep. 751. *Hungerford* v. *Earle*, 2 Freem. 120. Lane 22.; or where the money is to be paid to trustees to be vested in other estates, *Doe* v. *Martin*, 4 T. R. 39. Where a settlement is made with a power of revocation, it seems immaterial whether the settlement is merely voluntary, or upon valuable consideration, Sugd. Vend. 574. Rob. Conv. 637. And a settlement, made with power of revocation, will be void against a subsequent purchaser, although the grantor release or extinguish the power previously to the sale, *Bullock* v. *Thorne*, Mo. 615.; though it seems, it will be otherwise, if the release was for valuable consideration, or the purchaser had notice. That the statute does not extend to the power of charging the estate with a particular sum of money, *Jenkins* v. *Keymiss*, 1 Lev. 150. (ED.)

tion should be made, the said Act would serve for little or no purpose, and it would be no difficult matter to evade it: so (†) if A. had reserved to himself a power of revocation with the assent of B. and afterwards A. bargained and sold the land to another, this bargain and sale is good, and within the remedy of the said Act; for otherwise the good provision of the Act, by a small addition, and evil invention, would be defeated (T).

And on the same reason it was adjudged, 38 Eliz. in the Common Pleas, between Lee and his wife executrix of one Smith, plaintiff, and Mary (*f*) Colshil, executrix of Thomas Colshil, defendant, in debt on an obligation of one thousand marks, Rot. 1707.: the case was, Colshil the testator had the office of the Queen's customer, by letters patent, to him and his deputies; and by indenture between him and Smith, the testator of the plaintiff, and for six hundred pounds paid, and one hundred pounds per annum [83 a] to be paid during the life of Colshil, made a deputation of the said office to Smith; and Colshil covenanted with Smith, that if Colshil should die before him, that then his executors should repay him three hundred pounds. And divers covenants were in the said indenture concerning the said office, and the enjoying of it: and Colshil was bound to the said Smith in the said obligation to perform the covenants; and the breach was alleged in the non-payment of the said three hundred pounds, forasmuch as Smith survived Colshil: and although the said covenant to repay the three hundred pounds was lawful, yet forasmuch as the rest of the covenants were against the statute of (*a*) 5 E. 6. cap. 16. (U) and if the addition of a lawful covenant should make the obligation of force as to that, (*b*) the statute would serve for little or no purpose; for this cause it was adjudged, that the obligation was utterly void (W).

2nd, It was resolved, that if a man hath power of revocation, and afterwards, to

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(†) [1 Evan. Stat. 394.]

(T) Acc. *Lavender* v. *Blackstone*, 3 Kep. 526. Sugd. Vend. 5th edit. 574. Com. Dig. Covin B. 3. *Sup.* n. (S). (ED.)

(*f*) 2 And. 55. 107. Godb. 213. Cro. El. 529. Moor, 857. Ley, 2. 75. 79. [Vin. Abr. Offices O. 3. pl. 3.]

(*a*) Style 29. Cro. El. 520. Cro. Jac. 269. Hob. 75. Co. Lit. 234 a. 12 Co. 78. 3 Inst. 148. 154. 3 Keb. 26. 659, 660. 717, 718. 1 Brownl. 70, 71. 2 And. 55. 107. 3 Bulst. 91. 3 Leon. 33. 1 Rol. Rep. 157. 236. Goldsb. 180. [1 Saund. 66 a. (1). 3 Taunt. 244. 5 Taunt. 733. Vin. Abr. Void and Voidable A. pl. 8.]

(U) Part of the agreement was to procure a new grant to A. and B. and the survivor of them; and B. covenanted accordingly with A. that he upon request of A. would surrender the patent to the Queen, to the intent that a new one might be made according to the said agreement, which was for the office; and so the bond void, S. C. nom. *Smith* v. *Coleshill*, 2 And. 55. pl. 42. S. C. *id.* 107. pl. 58. nom. *Lee* v. *Coleshil*, S. C. Cro. Eliz. 529. pl. 58. Vin. Abr. Offices O. 3. pl. 3. On the construction of the statute 1 E. 6. c. 16, see 1 Inst. 234 a. ii. 239-241., and the notes there, 3 Inst. 148. 3 Cru. Dig. 139-144. (ED.)

(*b*) 2 And. 56, 57. 108. 1 Mod. Rep. 35, 36. Hob. 14. 11 Co. 27 b. 2 Rol. 28. Co. Lit. 224 a. 2 Jones, 90, 91. Cro. El. 529, 530. Cro. Car. 338. Godb. 212, 213. 1 Brownl. 64. Plowd. 68 b. Moor, 856, 857. Ley, 75. 79.

(W) So in *Norton* v. *Simmons*, Hob. 14. it was resolved, upon the statute 23 H. 6., that if a sheriff takes a bond for a point against that law, and also for a just debt, the whole bond is void according to the letter of the Act, for a statute is a strict law; but the common law divides according to common reason, and having made that void which is against law, lets the rest stand. And in Mod. 35. pl. 85. Twisden, J. said, he had heard Lord Hobart say, that the statute is like a tyrant in such cases, where he comes he makes all void; but the common law, like a nursing father, makes void only that part where the fault is, and preserves the rest. And see Moor, 856. pl. 1175. Godb. 213. *Post* 10 Co. 100. Latch. 143. Mod. 35. 2 Brownl. 82. Ventr. 257. Cart. 230. 2 Wils. 351. 1 Saund. 66 a. n. Willes 351. *Chesman* v. *Nainby*, 2 Ld. Raym. 1456. Stra. 1138. 5 T. R. 422. *Newman* v. *Newman*, 4 Maule and S. 66. 3 Taunt. 244. 5 Taunt. 733. Vin. Abr. Condition Y. pl. 7. Faits E. a. pl. 13. Bac. Abr. Void and Voidable B. 2. (ED.)

the intent to defraud a purchaser, he levies a (*c*) fine, or makes a feoffment, or other conveyance to a stranger, by which he extinguishes his power (X), and afterwards bargains and sells the land to another for a valuable consideration, the bargainee shall enjoy the land, for as to him, the fine, feoffment, or other conveyances, by which the condition was extinct, was void by the said Act; and so the first clause, by which all fraudulent and covinous conveyances are made void as to purchasers, extend to the last clause of the Act, *scil.* when he who makes the bargain and sale had power of revocation. And it was said, that the statute of 27 El. hath made voluntary estates made with power of revocation, as to purchasers, in equal degree with conveyances made by fraud and covin to defraud purchasers (Y).

Between (*d*) Upton and Basset in trespass, Trin. 37 El. in the Common Pleas, it was adjudged, that if a man makes a lease for years, by fraud and covin, and afterwards makes another lease *bona fide*, but without fine or rent reserved, that the second lessee should not avoid the first lease (Z).

For first it was agreed, that by the common law an estate made by fraud should be avoided only by him who had a former right, title, interest, debt or demand (A 1), as 33 H. 6. a sale in open (*e*) market by covin shall not bar a right which is more ancient: nor a covinous gift shall not defeat execution in respect of a former debt, as it is agreed in 22 Ass. 72. but he who hath right, title, interest, debt or demand, more puisne, shall not avoid a gift or estate precedent by fraud by the common law.

2nd, It was resolved, that no purchaser should avoid a precedent conveyance made by fraud and covin, but he who is a (*f*) purchaser for money or other valuable consideration (B 1), for although in the preamble it is said "for money or other good consideration," and likewise in the body of the Act "for money or other good consideration," yet these words "good consideration" are to be intended only of valuable

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(*c*) 1 Co. 112 b. 174 a. Co. Lit. 237 a. Hob. 337, 338. Moor. 605. 2 Rol. Rep. 337. 496. Winch. 65. [Shep. Touch. 64. 4 Cru. Dig. 525. Vin. Abr. Fraud L. pl. 3. Com. Dig. Covin B. 3.]

(X) That powers appendant and in gross may be extinguished by a feoffment, fine, or recovery, see *Digges's case, ante* 1 Co. 173. b. and n. (R 1). 174 a. 4 Cru. Dig. 214. Bac. Abr. Fines F. iii. 209. (ED.)

(Y) S. P. Mo. 618. Vin. Abr. Fraud L. pl. 4. Com. Dig. Covin B. 3. How a power of revocation shall make a deed fraudulent, and how it must be reserved to be executed, to make it so, see *id. ibid.* (ED.)

(*d*) Co. Ent. 676 b. nu. 19. Cro. El. 444, 445. Lane, 45. [2 Atk. 312. 1 Evan. Stat. 393. Shep. Touch. 66, ed. Ather. 1 Fonbl. Tr. Eq. 278. Sugd. Pow. 414. Vin. Abr. Fraud 1. pl. 7. K. pl. 2. Com. Dig. Covin B. 4. Bac. Abr. Fraud C. iii. 312, 313.]

(Z) That to take advantage of the statute 27 Eliz. the purchaser must have purchased *bona fide* without deceit or cunning, and for a valuable and not inadequate consideration, acc. 2 And. 233. *Taylor* v. *Jones*, 2 Atk. 600. *Doe* v. *Routledge*, Cowp. 705. *Bullock* v. *Sadlier*, Ambl. 764. *Doe* v. *James*, 16 East, 212. 1 Evan. Stat. 393. *Ante* p. 82 b. n. (R). and see the books cited in (*d*) *sup.* (ED.)

(A 1) S. P. 1 Fonbl. Tr. Eq. 278. n. 1 Madd. Ch. 278. 4 Cru. Dig. 517. Com. Dig. Covin B. 2. Bac. Abr. Fraud C. Vin. Abr. Fraud I. pl. 9. But per Lord Mansfield, C.J. the principles and rules of the common law, as now universally known and understood, are so strong against fraud in every shape, that the common law would have attainted every end proposed by the statutes of 13 Eliz. c. 5. and 27 Eliz. c. 4. Cowp. 434. (ED.)

(*e*) *Ante* 29 a, b. Plow. 46 b. 55 a. Fitz. Replic. 15. Br. Trespass 26. Br. Collusion 4. Br. Property 6. 2 Inst. 713. 14 H. 8. 8 b. 33 H. 6. 5 a. b. [see n. (A 1). *infra.*]

(*f*) Cro. El. 445. [5 Ves. 874. 1 Inst. ii. 238. (O). 2 Bl. Com. 444. Bull. N. P. 260. 1 Fonb. Tr. 280 n. 4 Cru. Dig. 527. Vin. Abr. Fraud 1. pl. 7. Com. Dig. Covin B. 4. Bac. Abr. Fraud C. 312, 313.]

(B 1) *Ante* p. 82 b. n. (R). *Sup.* n. (Z). and see the books cited in n. (*f*). *sup.* (ED.)

consideration (C 1); and that appears by the clause which concerns those who had power of revocation; for there it is said, for money or other good consideration paid, or given, and this word "paid" is to be referred to "money," and "given" is to be referred to "good consideration," so the sense is for money paid, or other good consideration given, which words exclude all considerations of **[83 b]** nature or blood, or the like, and are to be intended only of valuable considerations which may be given; and therefore he who makes a purchase of land for a valuable consideration, is only a purchaser within this statute. And this latter clause doth well expound these words "other good consideration" mentioned before in the preamble and body of the Act.

And so it was resolved, Pasch. 32 El. in a case referred out of the Chancery to the consideration of Windham and Periam, Justices: (†) between John Nedham plaintiff, and Beaumont serjeant at law, defendant: where the case was, Henry Babington seised in fee of the manor of Lit-Church in the county of Derby, by indenture 10 February 8 El. covenanted with the Lord Darcy, for the advancement of such heirs male, as well those he had begot, as those he should afterwards beget on the body of Mary then his wife (sister to the said Lord Darcy) before the Feast of St. John Baptist then next following, to levy a fine of the said manor to the use of the said Henry for his life, and afterwards to the use of the eldest issue male of the bodies of the said Henry and Mary begotten in tail, &c. and so to three issues of their bodies, &c. with the remainder to his right heirs. And afterwards 8 Maii, ann. 8 Eliz. Henry Babington, by fraud and covin, to defeat the said covenant, made a lease of the said manor for a great number of years, to Robert Heys; and afterwards levied the fine accordingly: and on conference had with the other justices, it was resolved, that although the issue was a purchaser, yet he was not a purchaser in vulgar and common intendment: also consideration of blood, natural affection, is a good consideration, but not such a good consideration which is intended by the stat. of 27 Eliz. for (*a*) a valuable consideration is only a good consideration within that Act (D 1): in this case Anderson C.J. of the Common Pleas, said, that a man who was of small understanding, and not able to (*b*) govern the lands which descended to him, and being given to riot and disorder, by mediation of his friends, openly conveyed his lands to them, on trust and confidence that he should take the profits for his maintenance, and that he should not have power to waste and consume the same; and afterwards, he being seduced by deceitful and covinous persons, for a small sum of money bargained and sold his land, being of a great value: this bargain, although it was for money, was holden to be (*c*) out of this statute (E 1): for this Act is made against all fraud and deceit, and doth not help any purchaser, who doth not come to the land for a good consideration lawfully and without fraud or deceit; and such conveyance made on trust is void as to him who purchases the land for a valuable consideration *bona fide*, without deceit or cunning (F 1).

And by the judgment of the whole Court Twyne was convicted of fraud, and he and all the others of a riot (1).

(C 1) Acc. *Taylor* v. *Jones*, 2 Atk. 600; and see Sugd. Pow. 2nd edit. 414. Shep. Touch. 64. n. ed. Ather. (ED.)

(†) 2 And. 233. [Sugd. Pow. 414. Vin. Abr. Uses S. 3. pl. 21. Com. Dig. Covin B. 4.]

(*a*) 2 Rol. Rep. 305, 306.

(D 1) See *ante* p. 82 b. n. (R). So if a purchaser upon consideration of nature, or blood, afterwards sells for valuable consideration; the vendee shall not avoid a voluntary settlement made prior to the settlement on his vendor. Mo. 602. Raym. 25. Com. Dig. Covin B. 4. (ED.)

(*b*) Cro. El. 445. [1 Evan. Stat. 391 n. Com. Dig. Covin B. 4.]

(*c*) Cro. El. 445.

(E 1) See *ante* p. 82 b. n. (R). and the books there cited. (ED.)

(F 1) That a conveyance in trust for payment of debts, is not, without other circumstances, sufficient to prevent the operation of the statute, see *Lord Paget's case*, 1 Leon. 194. *Leech* v. *Leech*, Ch. Ca. 249. *Tarback* v. *Marbury*, 2 Vern. 510. Rob. Conv. 431. 1 Evan. Stat. 391. (ED.)

(1) See 2 Bl. Com. ch. 20. fol. 296, 297. *Note to the former editions.*

[84 a] The Case of Fines.

The resolution of the justices, after hearing many arguments of counsel learned on both sides, and divers conferences amongst themselves upon the Statutes of Fines. Pasch. 44 Eliz. 1602.

[See *Hankey* v. *Martin*, 1883, 49 L. T. 562.]

S. C. Moor, 628. Jenk. Cent. 274. 2 And. 177. S. C. cited acc. Rep. Q. A. 20. Carth. 260. [1 Saund. 258. (8). 259, 260. (1). 261. (3). 319 c. 2 Ld. Raym. 780, 781. 1 Inst. 121 a. (1). ii. 610. (1). iii. 93. (A). 112. (P). 130, 131. (N 1). Shep. Touch. 3, 4. 13, 14. 20. ed. Prest. 4. 23, 24 n. 25, 26, 27. 29. 33. 36. ed. Ather. 3. n. 2 Wood's Convey. 744. 764, 765, 766, 767 n. 769. 775. 780 n. 799. Sugd. Gilb. Uses 218 n. 3 Cru. Dig. 7. V. 153. 185, 186, 187, 188, 189. 194, 195. 221, 222. 228. 258. 2 Saund. Uses 29. 2 Eun. 311. 2 Woodd. 311, 312. 1 Bart. Prec. 113. (6). 220 a. Watk. Desc. 291. Watk. Conv. 229. 1 Prest. Conv. 218, 219. 260. 296. 298. *Id.* Abst. 399. 2 Selw. N. P. 5th edit. 719. Vin. Abr. Dower F. pl. 9. Fine D. 2. pl. 1. D. 3. pl. 2. D. 4. pl. 1. D. 6. pl. 3. W. pl. 1. s. 2. W. 4. pl. 1. s. 3. 7. 9. W. 5. pl. 1. s. 1. D. a. 2. pl. 5. H. a. 2. pl. 2, 3. 8. D. b. 2. pl. 3. E. b. pl. 8. F. b. pl. 8, 9. Remainder U. pl. 3. Statutes E. 6. pl. 12. Com. Dig. Estates B. 23, 24, 25. Fine H. 1. K 2. Bac. Abr. Abatement K. Discontinuance B. E. Dower B. 3. Fines and Recoveries, E. Grants iii. 371. Heir and Ancestor B. 1. Remainder and Reversion G. V. 836. 850. Statute I. 4. See the notes and references *infra*.]

A. tenant for life, remainder to B. in tail, reversion to B. and his heirs; B. levied a fine with proclamations of the estate tail during the life of the tenant for life; and died before all the proclamations were passed leaving a son beyond sea, who did not return till after all the proclamations were made, and then claimed the land; held, 1st. That the estate which passed by the fine was not determined by the death of the tenant in tail; 2nd, That though by the death of the tenant in tail before all the proclamations passed, a right descended to the issue, yet after the proclamations were made, this right was bound by the express words of the statutes 4 H. 7. c. 4. and 32 H. 8. c. 36.; 3rd. That the issue being heir and privy could not by any claim have saved the right of the entail which descended to him; 4th. That though the issue in tail was beyond sea, yet inasmuch as he is privy and out of the savings of the 4 H. 7. he was barred by the fine.

Distinction between a grant in fee by tenant in tail of a rent *in esse*, and such a grant of a rent *de novo*, which is absolutely determined by his death.

A fine shall be intended to be levied with proclamations, until the contrary be shewn.

On a fine with proclamations by the discontinuee of tenant in tail, the issue have five years after the death of the ancestor to make claim. But where such a fine is levied by the disseisor of tenant in tail, and five years pass in the life of tenant in tail, the issue are barred.

Heirs in tail, or in fee, are estopped by the fine of the ancestor, under whom they claim: *secus* where they do not claim as heirs to him who levied the fine.

Distinction between tenant in tail levying a fine and his accepting a fine *sur* grant and render, which is but executory, and may be avoided by the issue, if the father dies before it is executed.

If tenant in tail accepts a fine, and grants and renders a rent, it may be avoided by the issue, not being of the land.

The issue in tail may be barred by a fine with proclamations, though the estate passed by the fine be avoided before all the proclamations are made.

A. tenant for life of certain land, the remainder to B. in tail, the reversion to B. and his heirs expectant; B. levies a fine to C. and D. and to the heirs of C. to the use of them and their heirs, and hath issue and dies before all the proclamations are past, the issue in tail then being beyond the seas; the proclamations are made, and after-

TAB 15

3B Bankr. Service L. Ed. § 34:158

Bankruptcy Service, Lawyers Edition | April 2023 Update

Chapter 34. Bankruptcy Code § 548

Code § 548. Fraudulent Transfers and Obligations

Part Two. Digest of Decisions

IV. Transfers Made with Actual Intent to Defraud [Code § 548(a)(1)(A)]

A. In General

§ 34:158. Nature and showing of intent—Relevance of particular party's intent—Control or domination of debtor

Summary

For an intentional fraudulent transfer claim, which requires actual intent, a company's intent may be established only through the actual intent of the individuals in a position to control the disposition of the transferor's property. 11 U.S.C.A. § 548(a)(1)(A). In re Tribune Company Fraudulent Conveyance Litigation, 10 F.4th 147 (2d Cir. 2021), cert. denied, 142 S. Ct. 1128, 212 L. Ed. 2d 18 (2022).

Court looks to state law to determine who has the authority to act on behalf of a corporation and therefore whose actions to review to see whether there was fraudulent intent or badges of fraud, in context of intentional fraudulent conveyance claims. 11 U.S.C.A. § 548(a)(1)(A). In re Tribune Company Fraudulent Conveyance Litigation, 10 F.4th 147 (2d Cir. 2021), cert. denied, 142 S. Ct. 1128, 212 L. Ed. 2d 18 (2022).

Although 11 U.S.C.A. § 548(a)(1) speaks only of intent of debtor, if transferee dominates debtor then fraudulent intent of transferee may be imputed to debtor. In re FBN Food Services, Inc., 185 B.R. 265, 34 Collier Bankr. Cas. 2d (MB) 1400 (N.D. Ill. 1995), aff'd and remanded, 82 F.3d 1387, 29 Bankr. Ct. Dec. (CRR) 29, 35 Collier Bankr. Cas. 2d (MB) 1193 (7th Cir. 1996).

To invoke the "control rule" to impute's transferee's intent to debtor/transferor on a claim for actual fraudulent transfer, a plaintiff must allege the following: (1) the controlling transferee possessed the requisite intent to hinder, delay, or defraud the debtor's creditors; (2) the transferee was in a position to dominate or control; and (3) the domination and control related to the debtor's disposition of the property. 11 U.S.C.A. § 548(a)(1)(A). U.S. Bank Nat. Ass'n v. Verizon Communications Inc., 817 F. Supp. 2d 934 (N.D. Tex. 2011).

When a transferee is in a position to dominate or control the debtor's disposition of the property, the transferee's intent to hinder, delay, or defraud will be imputed to the debtor-transferor. 11 U.S.C.A. § 548(a)(1)(A). In re Maxus Energy Corporation, 641 B.R. 467 (Bankr. D. Del. 2022).

The transferee's intent to hinder, delay, or defraud may be imputed to the debtor-transferor if the plaintiff proves that transferee possessed requisite intent to hinder, delay or defraud creditors, the transferee was in position to dominate or control debtor, and that domination and control related to debtor's disposition of property. 11 U.S.C.A. § 548(a)(1)(A). In re Maxus Energy Corporation, 641 B.R. 467 (Bankr. D. Del. 2022).

Under Maryland choice of law analysis, Maryland law, as law of the forum state, applied to question whether a corporate officer's fraudulent intent could be imputed to the corporation, in context of actual fraudulent conveyance action; while the parties pointed to various jurisdictions, the parties did not raise choice-of-law issue, and three of those jurisdictions, namely, Delaware, Maryland, and New Mexico, each followed traditional principles of agency and imputation law, such that there was no meaningful difference in the laws of those jurisdictions. 11 U.S.C.A. § 548(a)(1)(A). In re TMST, Inc., 610 B.R. 807 (Bankr. D. Md. 2019).

Determining whether a corporate officer's fraudulent intent may be imputed to the corporation, in context of action to avoid fraudulent prepetition transfer, is an issue governed by state law. 11 U.S.C.A. § 548(a)(1)(A). In re TMST, Inc., 610 B.R. 807 (Bankr. D. Md. 2019).

When recipient of alleged fraudulent transfer is in a position of dominance or control over debtor's disposition of its property, transferee's intent to hinder, delay, or defraud other creditors may be imputed to debtor so as to render the transfer avoidable as actually fraudulent to creditors under both the bankruptcy fraudulent transfer statute and the Massachusetts Uniform Fraudulent Transfer Act (MUFTA). 11 U.S.C.A. § 548(a)(1)(A); Mass. Gen. Laws Ann. ch. 109A, § 5(a)(1). In re Blast Fitness Group, LLC, 603 B.R. 219 (Bankr. D. Mass. 2019).

As is relevant to fraudulent-transfer claim, initial transferee is person who has dominion and control over subject of initial transfer to extent that he or she may dispose of it as he or she pleases; mere conduit is someone who possesses money but is powerless to put money to his or her own purposes. 11 U.S.C.A. § 548(a)(1)(A). Securities Investor Protection Corporation v. Bernard L. Madoff Investment Securities LLC, 638 B.R. 41 (Bankr. S.D. N.Y. 2022).

For purposes of alleging an actual fraudulent transfer claim, intent of the transferee is imputed to the transferor only where the transferee is in a position to control the debtor's disposition of his property. 11 U.S.C.A. § 548(a)(1)(A). In re Hellas Telecommunications (Luxembourg) II SCA, 526 B.R. 499, 60 Bankr. Ct. Dec. (CRR) 201, 73 Collier Bankr. Cas. 2d (MB) 965 (Bankr. S.D. N.Y. 2015).

For purposes of alleging an actual fraudulent transfer claim, intent of the transferee is imputed to the transferor only where the transferee is in a position to control the debtor's disposition of his property. 11 U.S.C.A. § 548(a)(1)(A). In re Hellas Telecommunications (Luxembourg) II SCA, 526 B.R. 499, 60 Bankr. Ct. Dec. (CRR) 201, 73 Collier Bankr. Cas. 2d (MB) 965 (Bankr. S.D. N.Y. 2015).

Appropriate standard in deciding whether fraudulent intent of corporate officer or employee may be imputed to corporate transferor, for fraudulent transfer avoidance purposes, is whether the individual whose intent is to be imputed was in position to control the disposition of transferor's property. 11 U.S.C.A. § 548(a)(1)(A). In re Lyondell Chemical Company, 503 B.R. 348 (Bankr. S.D. N.Y. 2014), as corrected, (Jan. 16, 2014) and (abrogated on other grounds by, In re Tribune Co. Fraudulent Conveyance Litigation, 818 F.3d 98 (2d Cir. 2016)).