

Tenth Circuit: Proceeds from Fraudulently Transferred Property Not Recoverable

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In *Rajala v. Spencer Fane LLP, et al., (In re Generation Res. Holding Co., LLC)*, No. 19-3226, 2020 WL 3887850 (10th Cir. July 10, 2020), the bankruptcy trustee sought to recover litigation proceeds from two law firms (Husch Blackwell LLP and Spencer Fane LLP) pursuant to section 550 of the Bankruptcy Code. The debtor, a power project developer, had formed three separate subsidiaries for each of its wind power projects (as part of a transaction with another developer, Edison Capital, that wished to acquire the projects), and then transferred its rights to development fees to two of these subsidiaries (LWHC and FWHC) at or around the time when the debtor was insolvent. After the debtor filed for chapter 7 bankruptcy, a dispute over final payment arose between one of the subsidiaries (LWHC) and Edison Capital. LWHC hired Husch Blackwell to sue Edison Capital in Pennsylvania district court, and won a \$9 million judgment. During this time, the bankruptcy trustee maintained that the disputed funds belonged to the bankruptcy estate, because the transfer of the right to payment by the debtor was fraudulent. The district court ordered that the litigation proceeds be deposited in the bankruptcy court's registry to determine whether they were part of the bankruptcy estate.

Spencer Fane was retained by LWHC and FWHC to represent them in the bankruptcy proceeding, and enforce the district court judgment; successfully asserted that the funds were not property of the bankruptcy estate, and secured the release of the funds to LWHC. LWHC distributed the funds, including its legal fees to both Husch Blackwell and Spencer Fane. The bankruptcy trustee filed fraudulent transfer claims against LWHC, FWHC and certain debtor insiders for the development fees, which resulted in the entry of a consent judgment, to which the law firms were not party, that empowered the trustee to recover the fees from LWHC and FWHC. When the trustee was unable to recover any of the funds, he then filed claims against the law firms seeking to recover the legal fees. The law firms' motions to dismiss were denied by the bankruptcy court and the matter certified to the Tenth Circuit Court of Appeals for an interlocutory appeal.

The Court of Appeals held that the trustee could not recover the payments because the firms were not "transferees" under section 550, which permits the recovery of "property transferred" from initial and subsequent transferees. The Court first reasoned that "property transferred" referred to the property that was "fraudulently transferred *in the first instance*," and argued that since the trustee asserted that the debtor had transferred its *right and interest to be paid the sales proceeds*, the property transferred could be no more than that "right and interest," or the contractual right to the sale proceeds. Next, the Court held that the law firms were not subsequent transferees because they never received the contractual right to the sale proceeds from LWHC, which was the initial transferee of the right.

The trustee also argued that cash proceeds may be considered as "property transferred" pursuant to section 541(a)(6) of the Bankruptcy Code, which defines "proceeds" as a form of estate property. In response, the Court agreed with the law firms' argument that since section 541(a)(3) identifies property recovered under section 550 as a separate category from proceeds (under section 541(a)(6)), proceeds could not also be available under section 550. Finally, the Court stated that there was no indication that Congress intended a trustee to trace proceeds derived from property against any person who received such proceeds as payment for goods and services.

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