UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

IN RE:

THE BENNETT FUNDING GROUP, INC.	CASE NO. 96-61376
	Chapter 11
Debtors	Substantively Consolidated

RICHARD C. BREEDEN, as trustee for
THE BENNETT FUNDING GROUP, INC., et al.

Plaintiff

vs. ADV. PRO. NO. 98-70037A

GLOUCESTER BANK AND TRUST COMPANY

Defendant

RICHARD C. BREEDEN, as trustee for
THE BENNETT FUNDING GROUP, INC., et al.

Plaintiff

vs. ADV. PRO. NO. 98-70021A

OXFORD BANK AND TRUST

Defendant

RICHARD C. BREEDEN, as trustee for
THE BENNETT FUNDING GROUP, INC., et al.

Plaintiff

vs. ADV. PRO. NO. 98-70023A

SPRAGUE NATIONAL BANK

Defendant

RICHARD C. BREEDEN, as trustee for
THE BENNETT FUNDING GROUP, INC., et al.

Plaintiff

vs. ADV. PRO. NO. 98-70027A

UNION STATE BANK

Defendant

RICHARD C. BREEDEN, as trustee for
THE BENNETT FUNDING GROUP, INC., et al.

Plaintiff

vs. ADV. PRO. NO. 98-70036A

FIRST UNITED SECURITY BANK

Defendant

RICHARD C. BREEDEN, as trustee for
THE BENNETT FUNDING GROUP, INC., et al.

Plaintiff

vs. ADV. PRO. NO. 98-70038A

THE HOWARD BANK, N.A.

Defendant

RICHARD C. BREEDEN, as trustee for
THE BENNETT FUNDING GROUP, INC., et al.

Plaintiff

vs. ADV. PRO. NO. 98-70039A

MERCHANTS NATIONAL BANK OF WINONA

Defendant

APPEARANCES:

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Hon. Stephen D. Gerling, Chief U.S. Bankruptcy Judge

MEMORANDUM-DECISION, FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER

Presently before the Court is a motion filed on June 29, 2000, on behalf of various defendant banks (collectively, the "Banks") requesting dismissal of certain causes of action asserted by Richard C. Breeden ("Trustee"), as chapter 11 trustee of the consolidated estates of The Bennett Funding Group, Inc. (collectively, the Debtors").[1] The Trustee, *inter alia*, seeks to avoid as fraudulent certain pre-petition transfers made by the Debtors to the Banks. Pursuant to Rule 7012(b) of the Federal Rules of Bankruptcy Procedure ("Fed.R.Bankr.P."), the Banks contend that the Trustee fails to state a claim under the actual fraudulent conveyance provision of New York's version of the Uniform Fraudulent Transfer Act ("UFCA"), codified as New York

[1] The Debtors are eight related entities which filed for bankruptcy under chapter 11 of the United States Bankruptcy Code, 11 U.S.C. §§ 101-1330 ("Code"), between March 29, 1996, and July 25, 1997, on which date the debtor estates were consolidated pursuant to an order of this Court.

Debtor & Creditor Law ("NYD&CL") § 276.

The motion was heard on July 13, 2000, in Utica, New York, and the matter was submitted for decision.[2]

JURISDICTIONAL STATEMENT

The Court has jurisdiction over the parties and subject matter of this aspect of the adversary proceeding pursuant to 28 U.S.C. §§ 1334 and 157(a), (b)(1), (b)(2)(A), (H), and (O).

PROCEDURAL HISTORY

On April 9, 1998, Gloucester Bank and Trust Co. ("Gloucester"), one of the Banks whose motion is under consideration herein, filed a motion pursuant to Rule 12(b) of the Federal Rules of Civil Procedure ("Fed.R.Civ.P."), as incorporated by reference in Fed.R.Bankr.P. 7012(b), seeking dismissal of the above-referenced adversary proceeding in its entirety. The Court issued a Memorandum-Decision, Findings of Fact, Conclusions of Law and Order on February 9, 1999, dismissing the Trustee's cause of action based upon Code § 548(a)(1)(B) and denying the Bank's motion with respect to the other relevant causes of action. *See Breeden v.Gloucester Bank and Trust Co.* (Bankr. N.D.NY. Feb. 9, 1999) ("Gloucester I Decision"). On March 17, 1999, the Court issued a separate decision in the remainder of the above-captioned adversary proceedings,

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[2] In their motions, the Banks also requested dismissal of the Trustee's causes of action based on constructive fraud pursuant to NYD&CL §§ 273, 274 and 275. The Court granted that portion of their motions.

incorporating and adopting the conclusions of law of the Gloucester I Decision in their entirety.

The Court issued a subsequent decision on April 27, 1999, addressing the motions and cross-motions for limited reconsideration of the Gloucester I Decision, denying the motions and cross-motions. *See Breeden v. Gloucester Bank and Trust Co.* (Bankr. N.D.N.Y. April 27, 1999) ("Gloucester II Decision"). On July 22, 1999, the Bankruptcy Appellate Panel for the Second Circuit ("BAP") granted leave to the Banks to appeal the Gloucester I Decision with respect to the issue of "fair consideration" in a constructive fraud cause of action based on NYD&CL §§273, 274 and 275. The BAP rendered its decision on May 25, 2000 ("BAP Decision"), concluding that only the good faith of the transferee, not that of the transferor, is to be considered when determining fair consideration for purposes of constructively fraudulent transfers.[3]

The motion now before the Court is a renewal of the motions previously filed by the Banks prior to the Gloucester I Decision asking again that the Court dismiss the Trustee's cause of action based on NYD&CL § 276 in light of the findings of the BAP.

ARGUMENTS

The Banks rely on a statement made by this Court in the Gloucester I Decision to the effect that "[i]f the Court were prepared to conclude as a matter of evidence or of law that

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[3] For purposes of this decision, the Court assumes a familiarity with both the Gloucester I Decision and the BAP Decision with respect to both the facts and the conclusions of law found therein.

Gloucester took the payments for fair consideration[4], this omission would be fatal to the Trustee's entire UFCA cause of action." *See* Gloucester I Decision at 33 (citation omitted). The Banks argue that the Trustee cannot prove something he has not alleged, and in his complaint he has not alleged that the Banks lacked good faith in their transactions with the Debtors. A similar argument is made by the Banks concerning the fact that the Trustee has not alleged that the Banks had any actual or constructive knowledge of the Debtors' alleged fraud.

The Trustee points out that the BAP's discussion focused on the Trustee's causes of action for constructive fraud for which the Trustee had the burden of establishing fair consideration. The Trustee argues that the BAP addressed what the Trustee had to allege to state a *prima facie* case for constructive fraud on the issue of good faith. According to the Trustee, the BAP made no finding with respect to whether Gloucester had acted in good faith in its dealings with the Debtors. Nor did it address "fair consideration" as a defense pursuant to NYD&CL § 278. The Trustee makes the argument that the motion previously before this Court was not one for summary judgment, and there has been no factual finding of good faith on the part of any of the Banks. The Trustee takes issue with the Banks' argument that it is the Trustee that bears the burden on the issue of good faith when fair consideration is raised as part of an affirmative defense pursuant to NYD&CL § 278. The Trustee also contends that the Banks have the burden of establishing not only their good faith but also their lack of knowledge of the Debtors' fraud pursuant to NYD&CL § 278. Therefore, it is the Trustee's position that the Banks' motions

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[4] NYD&CL § 272(a) states that "fair consideration is given for property, or obligation, [w]hen in exchange for such property, or obligation, as a fair equivalent therefor, and in good faith, property is conveyed or an antecedent debt is satisfied . . . ." NYD&Cl § 272 (McKinney's 1990 & Supp. 1999-2000).

should be denied.

DISCUSSION

As pointed out in the Gloucester I Decision, "[i]n considering a motion brought under Fed.R.Civ.P. 12(b)(6), which is made applicable to this proceeding by Fed.R.Bankr.P. 7012, this Court must accept all of the non-movant's allegations as true, and will grant the motion to dismiss "'only if is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations.'" Gloucester I Decision at 18, quoting *Hishon v. King & Spalding*, 467 U.S. 69, 73, 104 S.Ct. 2229, 81 L.Ed.2d (1984).

NYD&CL § 276 states that "[e]very conveyance made and every obligation incurred with actual intent . . . to hinder, delay or defraud either present or future creditors is fraudulent as to both present and future creditors." The Banks do not suggest that the Trustee has failed to state a claim based on the Debtors' actual intent to hinder, delay or defraud the creditors in this case, which would warrant dismissal. Instead, the Banks contend that the Trustee cannot prove something he has not alleged, namely the Banks' lack of good faith and the Banks' knowledge of the fraud.

The Banks' argument had merit in connection with the Trustee's causes of action for constructive fraud based on NYD&CL § 273, 274 and 275 because fair consideration was part of the Trustee's *prima facie* case and good faith, along with fair equivalent value, are necessary elements of "fair consideration." Thus, the Trustee had to allege *inter alia* that the Banks lacked good faith in order to state a claim for constructive fraud. However, the Banks' state of mind is

not a necessary element to the Trustee's NYD&CL § 276 cause of action and is not part of his *prima facie* case. *See Breeden v. Walnut Street Securities*, Adv. Pro. 98-70256A, slip op. at 9 (Bankr. N.D.N.Y. Nov. 24, 1998); *see also* Gloucester II Decision at 4 (noting that the transferee's good faith is irrelevant with respect to a cause of action based on actual fraud).

It is the Trustee's burden to aver and prove fraudulent intent on the part of the Debtors pursuant to NYD&CL § 276. *See In re Le Café Creme, Ltd*., 244 B.R. 221, 239 (Bankr. S.D.N.Y. 2000) (citations omitted); *Marine Midland Bank v. Murkoff*, 120 A.D.2d 122, 126, 508 N.Y.S.2d 17, 20 (N.Y.App.Div. 1986) Once he has established the Debtors' fraudulent intent,

> the obligation rests on the transferee to show that in good faith he paid a valuable consideration for the conveyance [footnote omitted] * * * If payment of consideration for the transfer has been shown by the transferee or purchaser, the burden of proceeding shifts back to the attacking creditor to show that at the time of the transfer and payment of the purchase money, the purchaser had knowledge of fraudulent intent on the part of the grantor or notice of facts which would have put him on inquiry and which, if followed, would have led to knowledge of the grantor's fraudulent intent.

37 AM.JUR.2D *Fraudulent Conveyances* § 217 (1968).

At this stage of the proceedings, the Court's focus, in the context of a motion to dismiss, is on the Trustee's pleadings. The question to be answered is whether he has stated a claim for which he is entitled to seek relief. It is the Debtors' intent that is at issue. As discussed in the Gloucester I Decision, "actual intent is a pure question of fact which does not lend itself to resolution on the pleadings." *See* Gloucester I Decision at 20 (citation omitted). If the Trustee were to prove his allegations concerning the Debtors' intent, then he would be entitled to avoid the transaction. However, proof of the Debtors' fraudulent intent would be insufficient to set

aside the conveyances if the Banks aver in their answers and prove that they took the payments in good faith and for fair equivalent value. *See Feist v. Druckerman*, 6 F.Supp. 751, 752 (E.D.N.Y. 1933), *aff'd* 70 F.2d 333 (2d Cir. 1934); *HBE Leasing Corp. v. Frank*, 48 F.3d 623, 639 (2d Cir. 1995); *see also Sec. Inv. Protection Corp. v. Stratton Oakmont, Inc.*, 234 B.R. 293, 318 (Bankr. S.D.N.Y. 1999) (citation omitted) (noting that good faith and fair equivalent value are to be asserted by the transferee as affirmative defenses to any recovery by the creditor).

In the Gloucester I Decision the Court stated that once Gloucester had proven good faith and fair equivalent value, it was the Trustee's burden to prove Gloucester's knowledge of the Debtors' fraudulent intent, citing to *Brody v. Pecoraro*, 250 N.Y. 56,164 N.E.741 (2d Cir. 1928). The court in *Brody* stated that "[i]f the grantor made the conveyance with fraudulent intent, the burden was on the grantee to show that he had accepted it for value, in which event the plaintiffs might have to prove that he had notice of the fraud." *Id.* at 62, 164 N.E. at 742 (emphasis added).

It must be remembered that pursuant to NYD&CL § 278, the grantee or transferee, in this case the Banks, have the burden of going forward with evidence of value and good faith in order to rebut the Trustee's *prima facie* case. "Good faith" is defined as "a state of mind indicating honesty and lawfulness of purpose . . . belief that one's conduct is not unconscionable or that known circumstances do not require further investigation . . ." WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 978 (1981). Under New York law, good faith generally requires proof of (1) an honest belief in the propriety of the activities in question; (2) no intent to take unconscionable advantage of others, and (3) no intent to, or knowledge of the fact that the activities in question will hinder, delay or defraud others." *Cf. Southern Industries, Inc. v. Jeremias*, 66 A.D.2d 178, 411 N.Y.S.2d 945, 949 (N.Y. App. Div. 1978) (listing the elements that

a person seeking to establish bad faith in order to set aside a conveyance must prove are lacking). If the Banks produce sufficient evidence to establish value and good faith, then the burden shifts back to the Trustee to counter the Banks' proof by establishing their knowledge of the Debtors' fraudulent intent.

The Trustee takes issue with his having the burden to prove the Banks' knowledge, relying on the case of *Emmi v. Patane*, 128 Misc. 901, 220 N.Y.S. 495 (N.Y.Sup. Ct. 1927). In that case, the state court found that under NYD&CL, the burden is on the grantee or transferee to prove that the conveyance was for fair consideration and without knowledge of the grantor's or transferor's fraud. *Id.* at 902, 220 N.Y.S. at 498. The court in *Emmi*, however, makes it clear that this burden arises "where on the face of the instrument the consideration is a nominal one." *Id.*

There is nothing in the Trustee's complaints/counterclaims to suggest that the monies loaned to the Debtors by the Banks were "nominal." Furthermore, as discussed above, in proving fair consideration, in particular, good faith, the Banks will have to produce evidence of their lack of knowledge of the Debtors' fraudulent intent before the Trustee is required to counter the Banks' proof that they did, indeed, have knowledge or had notice sufficient to warrant further inquiry; hence, the use of the word "might" by the court in *Brody* when discussing the Trustee's burden to prove the Banks' knowledge.

Because good faith and fair equivalent value are issues to be raised by the Banks in their answers in response to the Trustee's allegations of actual fraud, the Trustee's failure to allege a lack of good faith on the part of the Banks, as well as knowledge by the Banks' of the Debtors' fraudulent intent, is not a basis for dismissing his causes of action based on actual fraud pursuant to NYD&CL § 276. *See Stratton Oakmont*, 234 B.R. at 318.

This conclusion leaves the Court with having to address its statement in the Gloucester I Decision to the effect that because the Trustee did not allege Gloucester's actual or constructive knowledge of the Debtors' fraud, his "entire UFCA cause of action" would fail if the Court had been prepared to conclude that Gloucester had taken the payments from the Debtors for fair consideration. *See* Gloucester I Decision at 33. The statement was *dictum* which was not necessary to the Court's ruling and arguably may not have received the full and careful consideration that it should have. *See Saranoff v. American Home Prods. Corp.* , 798 F.2d 1075, 1084 (7th Cir. 1986). To quote Supreme Court Justice Robert H. Jackson of New York, "'if there are [] ways of gracefully and good naturedly surrendering former views to a better considered position, I invoke them all." *McGrath v. Kristensen*, 340 U.S. 162, 178, 71 S.Ct. 224, 233 (1950).

The statement made by this Court in the Gloucester I Decision is an accurate one insofar as the Trustee's causes of action based on constructive fraud under NYD&CL § 273, 274 and 275 are concerned. The Court finds, however, that it is not an accurate one insofar as the Trustee's cause of action based on NYD&CL § 276 is concerned. As discussed above, proof of the Banks' knowledge by the Trustee only becomes necessary in the event that the Trustee establishes the Debtors' actual fraudulent intent and the Banks are able to produce evidence of their good faith and fair equivalent value as an affirmative defense in connection with the transactions.

Based on the foregoing, it is hereby

ORDERED that the Banks' motion pursuant to Fed.R.Bankr.P. 7012(b), seeking dismissal of the Trustee's cause of action for actual fraud based on NYD&CL § 276, is denied.

Dated at Utica, New York

this 21st day of February 2001

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STEPHEN D. GERLING
Chief U.S. Bankruptcy Judge