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An Update on Texas Fraudulent Transfer Law

BY RUSSELL MILLS AND KENT LOVE

Texas adopted its version of the Uniform Fraudulent Transfer Act (TUFTA) in 1987. The law was designed to prevent debtors from prejudicing creditors by improperly moving assets beyond their reach. TUFTA permits creditors and bankruptcy trustees to "claw-back" payments or other transfers of property from a debtor's estate if such transfer was made "with actual intent to hinder, delay, or defraud" the debtor's other creditors. Because fraudulent intent is seldom susceptible to direct proof, TUFTA provides a non-exclusive list of eleven "badges" of fraud that may be used to infer that a debtor actually intended to defraud creditors.

Under TUFTA, however, a transferee is not required to relinquish the transfer if the transferee can prove it received the property "in good faith" and "for a reasonably equivalent value." Although often litigated, the term "good faith" is not defined by TUFTA and, until December of last year, had yet to be examined by the Supreme Court of Texas. In *Janvey v. GMAG, LLC*, No. 19-0452, 2019 WL 6972237 (Tex. Dec. 20, 2019), the Texas Supreme Court held that, to be entitled to TUFTA's good-faith defense, a transferee must show that its conduct was "honest in fact, reasonable in light of known facts, and free from willful ignorance of fraud."

The Texas Supreme Court answered a question certified to it by the Fifth Circuit by holding that a transferee on "inquiry" notice of the transferor's fraudulent intent cannot achieve good faith status unless it can show that it diligently investigated its suspicions. In *Janvey*, an investor in Stanford International Bank (which had operated as a Ponzi scheme and been placed into receivership because of it) was found to have received fraudulent transfers of almost $80 million and was denied good faith status. The Texas Supreme Court held that a transferee is on inquiry notice when he or she takes property with knowledge of such facts as would "excite the suspicions of a person of ordinary prudence" regarding the fraudulent nature of the transfer. In other words, a transferee is on inquiry notice when he or she knows facts that should be considered "red flags" that a reasonable person would have investigated prior to accepting the transfer.

Some courts in other jurisdictions follow the rule that a transferee on "inquiry notice" who fails to conduct an investigation can still achieve good faith status if the investigation would have been "futile." The lasting impact of the Court's decision in *Janvey* will be from its rejection of that "futility" exception in Texas law. The jury had found that a diligent inquiry by the *Janvey* investor, had one been undertaken, would not have revealed that Stanford was operating a Ponzi scheme because of its complexity. Yet, the Court held that a transferee on inquiry notice cannot achieve good faith status *even if the transferee's hypothetical investigation would have been fruitless and would not have revealed any fraudulent purpose*. The Court reasoned that imposing such a requirement on transferees negates any incentive a transferee may have to remain willfully ignorant of fraud.

Janvey was well-intentioned and reaches what seems to be a reasonable conclusion. However, the Court did not define what set of circumstances would constitute a "diligent investigation" sufficient to establish good faith, and its failure to define "diligent investigation" only produces more questions than answers. In order to have attained good faith status, must the *Janvey* investor have retained counsel to issue subpoenas to Stanford International Bank and fought with them over the production of confidential financial records all in an attempt to uncover what was "inherently undiscoverable"? Or would a simple Google search of their public records have been enough? And, what did the Court expect the *Janvey* investor to have done with the information he found in this investigation? Was he also expected to retain an accountant to parse through the complex scheme in an effort to uncover what the SEC, independent auditors, and 18,000 investors had not uncovered in 20 years? Is he expected to conduct his own review of the "badges" of fraud? What if the results of his "diligent" investigation found no fraud but this conclusion was simply incorrect? Can an investigation be "diligent" if it reaches the wrong result? In the end, the *Janvey* investor no doubt wishes he had done more, but it is hardly clear exactly what was expected of him.

While *Janvey* may have legitimately attempted to better define fraudulent transfer law in Texas, the Supreme Court instead produced more uncertainty. At a minimum, *Janvey* imposes a greater burden on transferees to perform a "diligent investigation" into potential wrongdoing. Practitioners should advise transferee clients to document the known circumstances, the parameters of any additional investigation, the results of the investigation, and the actions taken on those results. While these efforts may prove insufficient in hindsight, they would at least show that the transferee did attempt an investigation unlike the *Janvey* investor. **HN**

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