

Navigating Asset Tracing Challenges In Bankruptcy

By **Daniel Lowenthal** (December 11, 2023)

The uptick in bankruptcy cases will mean more work for insolvency professionals who specialize in asset tracing. Some of the most interesting work will arise in cases where companies engaged in significant fraud.

Each bankruptcy cycle has these cases. In 2001, Enron Corp. filed for bankruptcy. In 2008, there was Bernie Madoff. The latest example is FTX Trading Ltd.

But scores of less headline-grabbing cases will also require asset tracing. The work will be needed not just when there's intentional fraud, but also when constructive fraud and preferential transfers are present.

A big challenge for plaintiffs — debtors and post-confirmation liquidating trustees — can occur after a transfer is found to be voidable. It can be hard to locate, determine ownership of, and recover assets.

In the typical situation, a defendant receives funds from a debtor prepetition, commingles the money in one or more accounts, and transfers some amount of the funds to another person or entity.

Five common asset tracing rules that experts and courts use are the lowest intermediate balance rule, the restated tracing rules, last-in and first-out, first-in and first-out, and the pro rata method.

The lowest intermediate balance rule dates from English common law and was first recognized by the U.S. Supreme Court in *Cunningham v. Brown* in 1924.[1]

This rule assumes that the "secured funds deposited into a commingled bank account are the last funds disbursed from that account, and any disbursements made from the account are taken first from funds other than the ... secured funds until the balance in the account dips below the amount of those ... secured funds." [2]

As the U.S. Court of Appeals for the Fourth Circuit explained in *United States v. Miller* in 2018,

The lowest intermediate balance rule originated in trust law as a rule to determine the rights of a trust beneficiary to a trustee's bank account where the trust funds and the trustee's personal funds are commingled. In this regard, the Rule assumes that the funds at issue remain in the account and are available to be traced provided that the balance does not fall below the amount of the disputed funds. In the event that the balance of the account dips below the amount of funds at issue, the funds at issue abate accordingly.[4]

Less often cited in bankruptcy cases are the restated tracing rules. These provide that when "property of the claimant has been commingled by a recipient who is a conscious wrongdoer. Withdrawals that yield a traceable product and withdrawals that are dissipated are marshaled so far as possible in favor of the claimant."



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When an innocent recipient commingles the property, "restitution from property so identified may not exceed the amount for which the recipient is liable by [other rules.]"[5]

Last-in, first-out is the presumption that the last funds deposited into an account are the first to be withdrawn. This method is sometimes used as an alternative to the lowest intermediate balance rule.

First-in, first-out is the presumption that the first funds deposited into an account are the first to be withdrawn. Like last-in, first-out, this method is also an alternative to the lowest intermediate balance rule.

The pro rata methodology presumes that each claimant is entitled to a portion of commingled funds based on its percentage contribution to the account. This method lacks the timing element for deposits and withdraws that is present in the other methodologies.

According to the U.S. Court of Appeals for the Tenth Circuit's ruling in *United States v. Henshaw* in 2004, "courts exercise case-specific judgment to select the [tracing] method best suited to achieve a fair and equitable result on the facts before them."[6]

Bankruptcy courts "have broad discretion to determine which monies of commingled funds derive from fraudulent sources."[7]

As noted above, the lowest intermediate balance rule is widely utilized by experts and often cited in bankruptcy decisions. The November opinion from the Health Diagnostic Laboratory Inc.'s bankruptcy in the U.S. District Court of Eastern District of Virginia demonstrates how the lowest intermediate balance rule is applied.

In that case, the debtor sold test strips that provided early detection of cardiovascular disease, diabetes and more. The company and affiliates filed for Chapter 11 in 2015. The liquidating trustee brought multiple Chapter 5 avoidance actions.

One adversary proceeding concerned funds that HDL transferred to Bradford Johnson as an initial transferee. Johnson was a principal and sales agent of HDL's marketing consultant, BlueWave Healthcare Consultants Inc.

The trustee obtained a judgment against BlueWave of just over \$220 million. The court in HDL referred to this amount as the avoided transfers.

In 2018, Johnson and several of his business entities filed for bankruptcy in Alabama, a filing that stayed the trustee's lawsuit against him.

But Johnson had used funds he received from HDL to make charitable contributions to First United Methodist Church Centre, Alabama. The trustee pursued recovery against the defendant.

The trustee and the defendant stipulated that Johnson had received \$1,719,200.61 in transfers from HDL. The HDL decision referred to those funds as the avoidable transfers.

As noted above, the trustee could not pursue recovery from Johnson given the automatic stay in his bankruptcy case, and thus the transfers of these funds were avoidable but could not be avoided.

The evidence at trial showed that \$1,085,000 that had been transferred from HDL to Johnson were sent as donations from Johnson to the defendant from four commingled accounts, including a BlueWave account.

The question before the court was how much of what was transferred to the defendant from the commingled accounts was part of the avoided transfers and the avoidable transfers.

In other words, not necessarily all funds that Johnson had sent the defendant were subject to Chapter 5 recovery, even if Johnson had initially received those and other funds from HDL.

The trustee's expert examined all the inflows and outflows concerning those accounts on a transaction-by-transaction basis. Millions of dollars had moved in, out of, and between the accounts. A complicating factor was that the accounts included funds from sources other than HDL.

To trace the transfers from those accounts to the defendant, the expert relied primarily on the lowest intermediate balance rule method, but also utilized the restated tracing rules.

The assumption under the lowest intermediate balance rule was that all non-HDL funds in the commingled accounts were deemed to have been transferred out before disbursement of the funds from HDL.

Applying the lowest intermediate balance rule, the evidence showed that of the total \$1,085,000 transferred to the defendant from the four commingled accounts, \$569,435 could be traced directly to the avoided transfers and the avoidable transfers.

The other transfers were not subject to the trustee's avoiding powers. As a result, the court entered judgment in favor of the liquidating trustee and against the defendant for \$569,435.

The decision shows how an expert can make sense of a complicated situation. Millions of dollars of funds entered accounts from multiple sources, and funds also moved between those accounts.

Certain transfers from HDL through those accounts and to the defendant were subject to clawback under federal and state law.

Use of the lowest intermediate balance rule in this case enabled the expert to identify the subset of transfers that the liquidating trustee could seek to recover for the beneficiaries of the trust.

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[1] *Cunningham v. Brown*, 265 U.S. 1 (1924).

[2] Health Diagnostic Laboratory, Inc., No. 22-03023, 2022 Bankr. LEXIS 2721, at *10 (Bankr. E.D. Va. Nov. 9, 2023).

[3] Id. at *14-15.

[4] United States v. Miller, 295 F. Supp. 3d 690, 703-04 (E.D. Va. 2018), aff'd, 911 F.3d 229 (4th Cir. 2018).

[5] Id. § 59(3).

[6] United States v. Henshaw, 388 F.3d 738, 741 (10th Cir. 2004).

[7] Picard v. Charles Ellerin Revocable Tr. (In re Bernard L. Madoff Inc. Sec. LLC), No. 08-01789 (BRL), 2012 Bankr. LEXIS 1099, at *8 n.7 (Bankr. S.D.N.Y. 2011).