Maximizing Value Along the Fraudulent Transfer Chain: What Must Be Avoided, and Who Must Be Sued?

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Introduction

Section 548 of the Bankruptcy Code (the "Code") authorizes a trustee[1] to avoid transfers that are made with intent to hinder, delay, or defraud creditors.[2] In addition, section 544(b) of the Code permits a trustee to step into the shoes of an actual unsecured creditor and assert applicable state-law avoidance claims that oftentimes have a longer statute of limitations period than the analog Code provision.[3] To qualify as a transferee, the recipient generally must have dominion or control over the transferred assets.[4] Complicating matters, many fraudulent transfer claims involve not only an initial transferee, but also one or more subsequent transferees.[5] Section 550 of the Code, then allows a trustee to recover an avoided transfer of property from the initial transferee, the entity for whose benefit the transfer was made, or "***any immediate or mediate transferee***" of the initial transferee.[6]

While the foregoing Code provisions may appear straightforward, courts' applications of those provisions have resulted in inconsistent rulings and a lot of confusion. Two of the main issues where courts disagree are: (i) whether the trustee must actually avoid the initial transfer before recovering from a subsequent transferee; and (ii) whether the initial transferee must be a named defendant in an action.

In *Phillips v. SS Associates*, Judge Goldblatt of the Delaware Bankruptcy Court (the "Court"), recently addressed both questions. The Court held that a trustee seeking to recover from a subsequent transferee must first prove each element necessary to avoid the initial transfer and actually avoid the transfer. However, the Court held that the trustee does not need to name the initial transferee as a party to the action.[7] Accordingly, this decision offers practical guidance for the prosecution of fraudulent transfer actions in Delaware and may influence how other courts within the Third Circuit may approach similar claims in the future. For trade creditors and other vendors, the main takeaway is that a party that received funds downstream may still face fraudulent transfer exposure even if the alleged initial wrongdoer is not named in the lawsuit.

Procedural Background and Facts

Elchonon Schwartz ("Schwartz"), the principal of Nightingale Properties LLC (the "Debtor"), purported to raise money from investors for real estate investments, but instead diverted those funds into his personal account.[8] Schwartz pled guilty to wire fraud and admitted that he had misappropriated and converted $62.8 million of funds.[9] As part of this scheme, in May 2022, Schwartz transferred $250,000 to SS Associates (the "Defendant")[10] from his personal account.[11] Before commencing an avoidance action against Schwartz, the trustee settled with him, so Schwartz could not be sued directly to avoid the transfers he

1 For purposes of this article, references to a trustee also refer to the debtor and any other post confirmation fiduciary. See 11 U.S.C. § 1107(a).
2 11 U.S.C. § 548(a)(1)(A).
3 11 U.S.C. § 544(b)(1).
4 *See Andreini & Co. v. Pony Express Delivery Servs.*, 440 F.3d1296, 1300 (11th Cir. 2006).
5 See, e.g., *Image Masters, Inc. v. Chase Home Fin.,* 489 B.R. 375 (E.D. Pa. 2013; see also *In Re Glob. Prot. USA, Inc.,* 546 B.R. 586 (Bankr. D.N.J. 2016).
6 11 U.S.C. § 550(a)(2) (emphasis added).
7 *See Phillips v. SS Assocs. LLC (In re ONH AFC CS Invs. LLC)*, *6 (Bankr. Del. Feb. 4, 2026).
8 *Id.* at *6.
9 *Id.* at *7. *Head of Commercial Real Estate Investment Firm Pleads Guilty in $62.8M Investment Fraud Scheme*, OFFICE OF PUB. AFFS. AT U.S. DEP'T OF JUST., (Feb 13, 2025) https://www.justice.gov/opa/pr/head-commercial-real-estate-investment-firm-pleads-guilty-628m-investment-fraud-scheme.
10 *Phillips* at *7–*8.
11 *Id.*

received from the Debtor and then subsequently made to Defendant.[12]

The complaint "waffle[d] a bit" about whether the Defendant was the initial transferee or a subsequent transferee.[13] But, the Court found that the trustee sought to avoid the subsequent transfer to Defendant and to recover the funds from the Defendant despite not naming Schwartz in the lawsuit and previously settling with him. The Defendant moved to dismiss, arguing that a trustee cannot recover from a subsequent transferee without (i) first actually avoiding the initial transfer, and (ii) naming the initial transferee as a party to an action seeking avoidance of the subsequent transfer.[14]

The Court's Decision

The Court addressed two interrelated issues. First, must a trustee actually avoid the initial transfer before recovering from a subsequent transferee? Second, must the initial transferee be named as a party to the lawsuit, or may the trustee proceed directly against the subsequent transferee? In its decision, the Court conducted a thorough analysis of sections 548, 544(b), and 550 of the Code. Ultimately, the Court held: (i) the trustee must prove each of the elements necessary to avoid the initial transfer, and actually avoid the initial transfer, and (ii) the initial transferee does not need to be a named party to the lawsuit.[15]

The Defendant sought to dismiss the adversary proceeding because the initial transfer must be avoided – and it was not vis-à-vis Schwartz – and Schwartz was also not a named party in the lawsuit.[16] While the Court agreed with the Defendant that the initial transfer must be avoided, the Court disagreed that naming Schwartz as a party to the lawsuit was required for the suit to move forward.[17] Judge Goldblatt ultimately dismissed the complaint "with leave for the trustee to file an appropriate amended complaint within 30 days."[18] To date, an amended complaint does not appear to have been filed.

The Court's decision deviates from other circuit and district courts' holdings on these issues. For example, the Tenth and Eleventh Circuits both had previously held that to avoid the initial transfer, the trustee must name the initial transferee as a defendant.[19] When discussing whether a transfer needed to actually be avoided or if being merely avoidable was sufficient, the Court also distinguished its holding from other decisions that held actual avoidance was not a prerequisite for recovery. For example, in *SIPC v. Madoff*, the court there held that there is no language in the Code's avoidance provisions requiring that "avoidance must be brought – or fully adjudicated – against an initial transferee for recovery proceedings to go forward against a subsequent transferee."[20] Here, however, the Court held that the trustee must actually avoid the initial transfer before the trustee can recover from the subsequent transferee under section 550 of the Code.[21]

At the same time, the Court observed that most courts have correctly decided the issue of whether the initial transferee needs to be a named party and held that a trustee can avoid and seek recovery of a transfer without actually suing the initial transferee.[22] In reaching his conclusion, Judge Goldblatt analogized this issue to vicarious liability. A plaintiff suing a store for a clerk's negligence does not need to also personally

12 *Philips* at *3.
13 *Id.* at *2.
14 *Id.* at *3.
15 *Id.* at *17.
16 *Id.* at *13.
17 *Id.*
18 *Id.* at *6 ("Counsel for the trustee made clear at argument that [recovery from a *subsequent* transferee after the *initial* transfer is avoided] is what the trustee seeks to accomplish.").
19 *See In re International Administrative Services, Inc.*, 408 F.3d 689, 704 (11th Cir. 2005) and *In re Slack-Horner Foundries Co.*, 971 F.2d 577, 580 (10th Cir. 1992). *See also In re Trans-End Technology, Inc.*, 230 B.R. 101, 105 (Bankr. N.D. Ohio 1998).
20 *Securities Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 501 B.R. 26, 31 (S.D.N.Y. 2013).
21 *Phillips*, at *19.
22 *See Phillips*, at *13. The court cites *Image Masers, Inc. v. Chase Home Fin.*, 489 B.R. 375, 398 n.18 (E.D. Pa 2013), *In re Advanced Telecomm. Network, Inc.*, 321 B.R. 308, 328 (M.D. Fla 2005), and *In re AVI, Inc.*, 389 B.R. 721, 734 (B.A.P. 9th Cir. 2008) to support its position that the initial transferee does not need to be a named party for the trustee to recover from the subsequent transferee.

sue the clerk. Similarly, if a trustee proves that the initial transfer was fraudulent (i.e., avoids the transfer), the court can avoid that transfer for purposes of recovery from the subsequent transferee, even if the initial transferee is not before the court.[23]

Conclusion

Under *Phillips*, a trustee seeking to recover funds from a subsequent transferee must actually avoid the initial transfer, but the trustee does not need to name the initial transferee as a party in an action against a subsequent transferee. For vendors, suppliers, and other trade creditors, the decision highlights an important proposition: receiving funds indirectly does not necessarily insulate a party from fraudulent transfer exposure. Based on this decision, a trustee may be able to pursue a later recipient in the transfer chain without also suing the initial transferee, provided the trustee avoids the initial transfer, which was likely complicated here due to the settlement with Schwartz.

The decision is especially relevant in Delaware bankruptcy cases and is likely persuasive authority within other courts in the Third Circuit, where there is no controlling decision. Although the amount in controversy in *Phillips* may make appellate review unlikely, and an amended complaint does not seem to have been filed, the decision gives trustees—and potential fraudulent transfer defendants—a clearer roadmap for litigating fraudulent transfer claims involving multiple transferees along the transfer chain.

23 *Id.* at *17.

About the Authors



Eric Chafetz is a trusted advisor to creditors' committees and individual trade creditors, debtors, and plan/liquidating trustees involved in complex Chapter 11 bankruptcies throughout the United States. He advises clients across a wide range of industries and has a strong track record in bankruptcy-related litigation, including investigating and prosecuting actions against officers, directors, and lenders, as well as in prosecuting and defending preference/fraudulent transfer actions.



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