

Expert Analysis

# 3rd Circ.'s New Damages Formula For Entireties Fraud Cases

By Shane Ramsey

Law360 (March 7, 2019, 4:21 PM EST) – In a Feb. 20, 2019, opinion in *In re Titus*,<sup>[1]</sup> the U.S. Court of Appeals for the Third Circuit, in an opinion authored by Judge Thomas Ambro, announced a new test for calculating damages in fraudulent transfer actions involving tenancy by the entireties transfers.



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## Facts

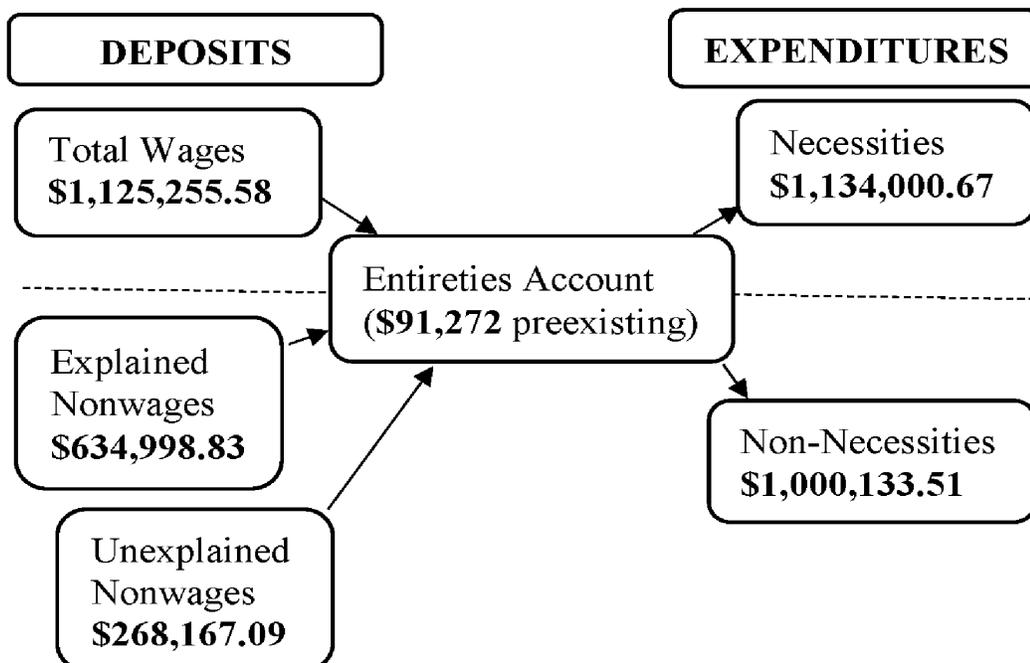
This case involved Paul Titus, a partner in a law firm, who was saddled with millions of dollars of liability for his guarantee of the dissolved firm’s lease. While working at a new firm, he became subject to a multimillion-dollar judgment in favor of the landlord.

To avoid having income from his new firm garnished, he directed the firm to deposit his income directly into an entireties account in his name and his wife’s. Because his wife was not liable on the judgment, the landlord could not attach the joint bank account.

The judgment later forced the partner into bankruptcy. During the bankruptcy, the trustee sued the debtor and his wife to recover fraudulent transfers under the Pennsylvania Uniform Fraudulent Transfer Act.

After a first trial, the Bankruptcy Court concluded that the direct deposit of wages into the Tituses’ bank account was a fraudulent transfer that the trustee could recover from either Paul or Bonnie Titus, who jointly owned the account as tenants by the entirety.<sup>[2]</sup> As for the measure of liability, the Tituses were liable for the amount of Paul Titus’ wages that were “not spent on necessities.”<sup>[3]</sup>

After a second trial, the Bankruptcy Court made the following findings as to deposits into, and expenditures from, the bank account:<sup>[4]</sup>



Using the figures set out above, the court went about calculating damages, but it immediately hit a roadblock: “Because money is fungible and wage and nonwage deposits commingled in the account, it was impossible to determine whether a dollar of wages was eventually spent on a permissible “necessity” or an impermissible ‘non-necessity.’ As a result, the Court had to calculate liability indirectly.”[5]

The court did this by using what it could measure: nonwage deposits and nonessential spending, which are represented below the dotted line in the chart above. The court’s underlying assumption was that all explained nonwage sources of cash in the account (both explained nonwage deposits and cash already in the account) were spent on non-necessities before any wage deposits were impermissibly spent on whatever nonessentials remained. Thus the Tituses’ total liability was:

$$(Non-Necessities) - (Explained Nonwages) - (Initial Balance) = \$1,000,133.51 - \$634,998.83 - \$91,272.00 = \$273,862.68.[6]$$

The district court affirmed. Both the couple and the trustee appealed.

### **The Third Circuit’s Ruling**

#### ***Liability***

The court had no difficulty finding fraudulent transfer liability. “When the wages of an insolvent spouse are deposited into a couple’s entireties account, both spouses are fraudulent transferees,” the court stated.[7]

The Third Circuit presumes that transfers into an entireties account are not made for reasonably equivalent value.[8] Because the debtor was insolvent, the transfers of the debtor’s income were therefore fraudulent transfers.[9]

#### ***Damages***

The more difficult question was that of calculating damages. In the instant case, this was made tricky because some of the funds in the account came from the wife or sources that were not fraudulent transfers. And courts have held there is no liability when money is spent for reasonable and necessary household expenses. In that regard, the trustee must “prove by a preponderance of the evidence that [the debtor’s] wage deposits were not spent on necessities.”[10]

Judge Ambro noted that the trustee faces “what appears to be an impossible task in a commingled account.” Because money is fungible, it may be impossible to determine what deposit was used for a particular expenditure.

Judge Ambro then went on to discuss a damages formula that was first advocated for by the Bankruptcy Court for the Western District of Pennsylvania, and that the Third Circuit went on to adopt in Titus.

#### ***The Pro Rata Formula***

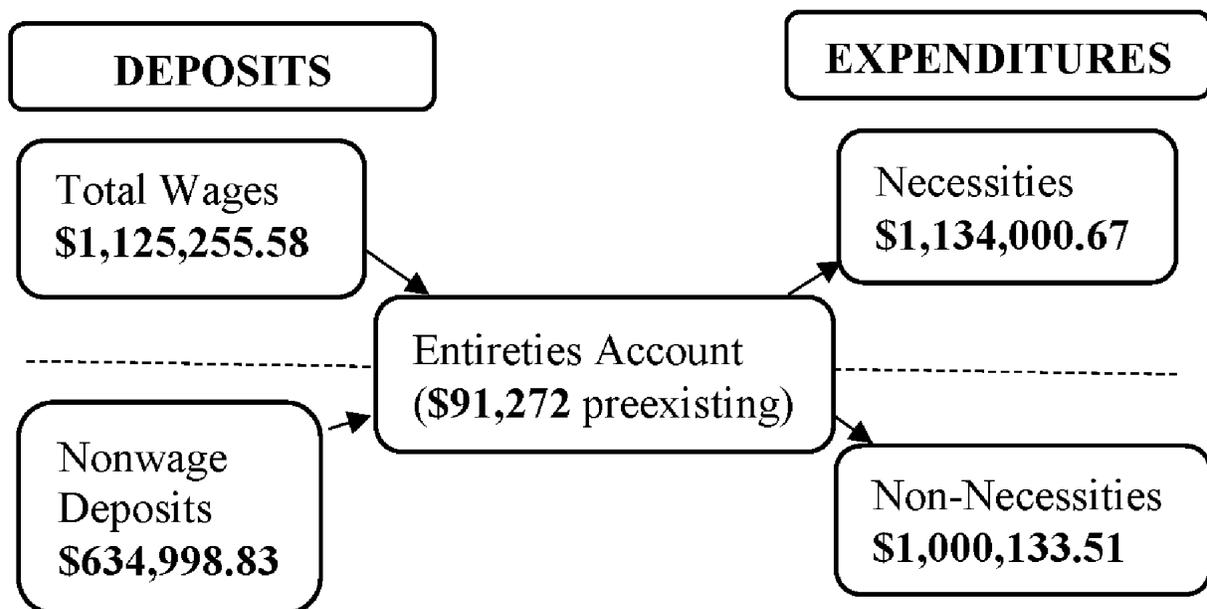
For “future courts facing commingled funds,” the Third Circuit set forth the “pro rata” formula for damage calculation. The court said it “accounts for the fungibility of wage and nonwage funds that are commingled.”

The formula is applied as follows: First, calculate the deposits that were fraudulent transfers and those that were not. In Titus, the debtor’s wages represented fraudulent transfers equaling about 60 percent of the deposits into the joint account. Payments from the account totaled about \$2.1 million, of which about \$1 million were for nonessentials.

Applying the percentage of fraudulent deposits to the expenses for nonessentials, the court said that the judgment should have been approximately \$600,000 — \$325,000 more than the \$275,000 in damages calculated by the bankruptcy court below.

The Third Circuit aptly described the formula as follows:

The pro rata approach accounts for the fungibility of wage and nonwage funds that are commingled in the entireties account. In our case, the liability would be calculated based on the inflows and outflows found by the second Bankruptcy Court decision (for simplicity, and to be consistent with our conclusion in the next section, we have eliminated “unexplained” nonwage deposits):



The total amount of money flowing into the account is the sum of wage deposits, nonwage deposits and preexisting cash in the account:

$$\text{Total Inflows} = (\text{Wages}) + (\text{Nonwages}) + (\text{Preexisting Cash}) = (\$1,125,255.58) + (\$634,998.83) + (\$91,272) = \$1,851,526.41.$$

Thus the calculation of wage deposits as a percentage of total inflows is:

$$(\text{Wage Deposits}) / (\text{Total Inflows}) = (\$1,125,255.58) / (\$1,851,526.41) = 60.8\%.$$

Hence we can presume that, of the \$1,000,133.51 spent on nonessentials, 60.8 percent impermissibly came from wage deposits. The Tituses' liability would be that wage-derived portion:

$$(0.608) * (\$1,000,133.51) = \$607,825.96.[11]$$

The court then concluded by stating: "Eyeballing these figures, we note that this measure of liability makes intuitive sense: Wages account for just under two-thirds of all deposits into the account, so it stands to reason that just under two-thirds of all non-necessity spending came from wage deposits. Appropriately, then, the Tituses' liability under the pro rata approach would be just under two-thirds of all non-necessity spending." [12]

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[1] In re: Paul H. Titus, --- F.3d ---- 2019 WL 693026 (3d Cir. Feb. 20, 2019).

[2] Id.at \*1.

[3] Id.

[4] Id. at \*2.

[5] Id.

[6] Id.

[7] Id.at \*1.

[8] Id.at \*5.

[9] Id.

[10] Id.

[11] Id.at \*6-7.

[12] Id.at 7.