AVOIDING FRAUDULENT TRANSFERS

I. INTRODUCTION

"The delightful quality of fraud lies in its infinite variety.…"[1] The concept of a "fraudulent transfer or conveyance" has its roots in 16th century British law, the Statute of 13 Elizabeth, Chapter 5 (1570). As one modern court noted, "The [Statute of Elizabeth] was aimed at a practice by which overburdened debtors placed their assets in friendly hands thereby frustrating creditors' attempts to satisfy their claims against the debtor," only to have the assets returned to the debtor after the creditors had given up their collection efforts.[2]

Current restrictions on such efforts to defraud creditors are embodied in both federal and state law. Modern fraudulent conveyance law includes both traditional actual fraud, where the company acts with the intent to hinder, delay or defraud its creditors, and a broader concept of constructive fraud, where the financially strapped company engages in transactions that result in a transfer of assets in exchange for something less than the reasonably equivalent value of those assets.

Lenders should be aware of the elements of fraudulent transfer in order to avoid the potential risks associated therewith, particularly with loans related to leveraged buyouts and intercompany guarantees.

II. FRAUDULENT TRANSFERS UNDER THE BANKRUPTCY CODE AND APPLICABLE STATE LAW

A. Trustee or Debtor in Possession's Avoiding Powers Generally

1. Sections 542-553 of the Bankruptcy Code grant a Debtor in Possession or Trustee the power to "avoid" certain transfers and recover assets for the benefit of the bankruptcy estate, including transfers that "prefer" one creditor over another and fraudulent transfers.

B. Section 548 of the Bankruptcy Code

1. Under Section 548 of the Bankruptcy Code, a trustee or debtor in possession may avoid any transfer of the debtor's interest in property or obligation of the debtor that was made or incurred on or within one year before the date of the filing of the bankruptcy petition, under the following circumstances:

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1 *Carmel v. River Bank America, et al.*, 175 B.R. 671 (Bankr. N.D.Ill. 1994)(quoting Jack F. Williams, REVISITING THE PROPER LIMITS OF FRAUDULENT TRANSFER LAW, 8 Bankr.Rev. J. 55 (1991)).

2 *Mellon Bank, N.A. v. Metro Communications, Inc.*, 945 F.2d 635, 644-45 (3d Cir. 1991).

a. Actual Fraud

(i) Where the debtor, voluntarily or involuntarily made such transfer or incurred such obligation with actual intent to "hinder, delay or defraud" any current or future creditor.

(ii) "Intent to Hinder, Delay or Defraud"

(A) Proving that a debtor actually intended to defraud its creditors is very difficult. Intent may be inferred by the facts and circumstances surrounding the transaction. For example, a general scheme or plan to strip a debtor of its assets without regard to the needs of its creditors will support a finding of actual intent in the context of a fraudulent conveyance of property.[3]

(B) It is the intent of the transferor that is at issue, and not the intent of the transferee.[4]

(C) Circumstances considered "badges of fraud" by the courts include: (i) secretive transactions; (ii) an agreement not to record a transaction; (iii) transactions in which the transfer price is far below fair value; and (iv) transactions which take place while the debtor is being pursued by its creditors. Transactions between family members are also closely scrutinized.

(D) Where a transfer is made with the actual intent to hinder, delay, or defraud creditors, it is not necessary to show that the debtor was insolvent for the transfer to be voidable as fraudulent.[5]

b. Constructive Fraud

(i) Where the debtor voluntarily or involuntarily received less than "reasonably equivalent value" in exchange for such transfer or obligation, and

(A) was insolvent on the date of the transfer was made or the obligation was incurred, or was made insolvent by the transfer or obligation, or

[3] *Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488 (N.D. Ill. 1988).

[4] *In re Rubin Bros. Footwear, Inc*., 119 B.R. 416 (Bankr. S.D.N.Y. 1990).

[5] *In re Vaniman Intern., Inc.*, 22 B.R. 166 (Bankr. E.D.N.Y. 1982).

(B) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was unreasonably small capital, or

(C) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured ("constructive fraud").

(ii) "Reasonably Equivalent Value"

(A) "Value" means property, or satisfaction or securing of a present or antecedent debt of the debtor.[6]

(B) "Reasonably equivalent value" is the value on the date of the transfer in light of all of the circumstances. It is not necessarily the appraised value by the transferor and transferee as determined in an arm's-length transaction between a willing buyer and a willing seller.[7]

(C) A good faith transferee of a fraudulent transfer retains a lien on the property recovered to the extent of value given and the cost of improvements and increase in value as a result of such improvements.[8]

(iii) "Insolvent"

(A) A debtor is insolvent if the sum of a debtor's debts (including guaranty obligations) is greater than the fair value of the debtor's property, exclusive of (i) any property of the debtor that was transferred, concealed, or removed with intent to hinder, delay, or defraud the debtor's creditors, and (ii) any property exempt from the debtor's estate under Section 522 of the Bankruptcy Code.[9]

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[6] *Sender v. C&R Co.*, 149 B.R. 941 (D. Colo. 1992).

[7] *In re Robinson*, 80 B.R. 455 (Bankr. N.D. Ill 1987).

[8] 11 U.S.C. §§ 548(c), 550(e).

[9] 11 U.S.C. § 101(31).

C. State Fraudulent Transfer Laws

1. As an alternative to proceeding under Section 548 of the Bankruptcy Code, the Trustee also has the power, under Section 544(b) of the Bankruptcy Code, to avoid any transfer voidable under applicable state fraudulent transfer statutes or federal law by any actual unsecured creditor of the estate with an allowed claim.[10]

a. The advantage of this approach is that it enables the Trustee to use state fraudulent transfer statutes, which often have longer "reach-back" periods, allowing the Trustee to attack transfers made more than one year prior to the bankruptcy.

(i) In Illinois, for example, the statute of limitations on a fraudulent transfer action is generally four years after the transfer was made or the obligation was incurred or, if later, within one year after the transfer or obligations was or could reasonably have been discovered by the claimant.[11] In Michigan, the statute of limitations on a fraudulent transfer action is six years with a two year extension for concealed transfers from the date the claimant discovers, or should have discovered, the existence of the claim.[12]

b. The disadvantage of this approach is that it requires the existence of an actual unsecured creditor with standing under the applicable law. Some state causes of action are available only to creditors existing at the time of the transfer.

2. Most states' fraudulent transfer statutes are modeled either after the Uniform Fraudulent Conveyance Act ("UFCA") or Uniform Fraudulent Transfer Act ("UFTA"), which are closely related to the analysis under Section 548 of the Bankruptcy Code.

III. LEVERAGED BUYOUTS AS FRAUDULENT TRANSFERS

In the late 1980s and through the 1990s, as the heyday of highly leveraged transactions was followed by a spate of failed companies and unhappy creditors, there were significant developments in the application of fraudulent transfer laws to leveraged buyouts. Through the application of the constructive fraud analysis, courts are able to collapse the often-complex structure of a leveraged deal, and void the total transaction as a fraudulent transfer.

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[10] 11 U.S.C. §§ 502, 544(b).

[11] 740 ILCS 160/10.

[12] M.C.L. 600.5813 and M.C.L. 600.5855.

In its most basic form, an LBO involves the acquisition of a company (the "Target") financed primarily by loans made directly or indirectly to the acquiring entity (the "Purchaser") and secured by the Target's assets. The proceeds are advanced to the Purchaser, which uses the funds to pay the purchase price owed to the selling shareholders. Loans to the Purchaser are often supported by upstream guaranties from the Target and/or its affiliates and collateralized by a lien on all or substantially all of the Target's and affiliates' assets.

A. **Application of Fraudulent Transfer Analysis to LBOs.**

1. Several courts have applied the actual fraud standard to lenders involved in LBOs. The key here is that it is the debtor's intent that is at issue, not the lender's. If a court concludes that the LBO constituted an actual fraud on creditors, a lender can have its collateral and the debtor's obligations voided, even though it gave reasonably equivalent value.[13]

2. Most lenders are sued under a constructive fraud theory. In a claim to void a leveraged buyout transaction as a constructively fraudulent transfer, the trustee or debtor will make the following basic arguments:

   a. all of the many separate transactions which effectuate the buyout are collapsed and viewed as one transaction;

   b. one or more of the debtor corporations transferred value and/or assets by guaranteeing or securing a loan made to the acquiring company;

   c. the debtor corporation did not receive reasonably equivalent value in exchange for its guarantee or security, usually because the loan proceeds have been transferred to the Target/debtor's shareholders, and not retained by the Target/debtor; and

   d. the transaction resulted in making the debtor corporation insolvent, left the debtor corporation with unreasonably small capital, or resulted in the debtor incurring debts beyond its ability to pay such debts as they mature. [14]

B. **Practice Tips for Lenders in Avoiding LBO-Related Fraudulent Transfers**

1. Trying to avoid the fraudulent transfer pitfalls inherent in LBO transactions can get a lender into even more trouble. One case from the Northern

[13] *See, e.g., Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488 (N.D. Ill. 1988); *United States v. Tabor Court Realty Corp.*, 803 F.2d 1300 (3d Cir. 1986).

[14] *See*, 2000 COLLIER HANDBOOK FOR TRUSTEES AND DEBTORS IN POSSESSION.

District of Illinois suggests that trying to structure an LBO so as not to run afoul of the fraudulent conveyance laws may itself constitute actual fraud.[15]

2. The lender should confirm by appraisal and/or accountants that the Target/Borrower is solvent and will be left with reasonable capital after the LBO. An appraisal or accountant's opinion prepared at the time of the transaction is typically more credible to a Court than one conducted four years later.

3. The lender should also confirm the value retained by the Target/Borrower (*i.e.*, revolving credit facility, payoff of current secured credit facility), and the lender should document such consideration in the recitals of the loan documents.

IV. INTERCOMPANY GUARANTEES

A. Upstream Guarantees

1. A subsidiary's guarantee of a parent's obligation typically creates fraudulent transfer risks because the subsidiary seldom receives fair equivalent consideration for the guaranty. A lender must always ask: What benefits did the subsidiary receive for the guarantee. If such benefit exists, it should be documented in the guarantee for future defense against fraudulent transfer claims. A lender's underwriting of a loan must always consider the enforceability of a subsidiary's guarantee for a parent's obligation.

2. Fair equivalent value may be found under the "enterprise theory," in which a parent and subsidiary are part of an enterprise where each of their businesses benefits the other (for example, where the parent is a manufacturer and the subsidiary provides the sales and marketing services or transportation of the parent's products).

B. Cross-Stream Guarantees

1. A sister affiliate's guarantee of another affiliate's obligations creates the same fraudulent transfer risks of upstream guarantees, requiring the same analysis set forth above.

2. Again, the enterprise theory may provide the fair equivalent value necessary to defend the enforcement of the affiliate's guarantee.

C. Downstream Guarantees

1. Typically, guarantees by a parent of a subsidiary's obligations are deemed enforceable, and are subject to lesser fraudulent transfer risks, because

[15] *Wieboldt*, 94 B.R. at 504.

the parent (as owner of the subsidiary) likely receives value from the enhanced credit.

V. OTHER TRANSFERS AS FRAUDULENT CONVEYANCES

A. <u>Real Estate Foreclosures as Fraudulent Transfers</u>

1. A real estate foreclosure is a "transfer" under the Bankruptcy Code and is subject to avoidance as a fraudulent transfer under Section 548.

2. Some jurisdictions have held that seventy percent or more of fair market value of the property to be foreclosed constitutes "reasonably equivalent value" under Section 548.[16]

3. The Seventh Circuit rejected the seventy percent rule in favor of an "all facts and circumstances" approach. Under this approach, "reasonably equivalent value" in the real estate foreclosure context depends on "all the facts of each case," including the impact that the foreclosure itself has on the market value of the property.[17]

4. The Supreme Court of the United States has rejected that "reasonably equivalent value" is either "fair market value" or "fair foreclosure price" (as calculated as a percentage of fair market value or otherwise), but is "the price in fact received at the foreclosure sale, so long as all the requirements of the State's foreclosure law have been complied with."[18]

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[16] *Durrett v. Washington Nat. Ins. Co.*, 621 F.2d 201 (5th Cir. 1980).

[17] *Bundles v. Baker (In re Bundles)*, 856 F.2d 815 (7th Cir. 1988).

[18] *BFP v. Resolution Trust Corp.*, 114 S. Ct. 1757, 1765 (1994).