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**CAVEAT EMPTOR, FAENERATOR, AND
COACTOR: FRAUDULENT TRANSFER AND
PREFERENCE ISSUES IN BUSINESS SALES,
FINANCINGS, AND COLLECTIONS**

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© Kenneth L. Cannon II
DURHAM JONES & PINEGAR
111 East Broadway, # 900
P.O. Box 4050
Salt Lake City, Utah 84111
Telephone: 801-415-3000
Email: kcannon@djplaw.com

I. Introduction

We all know the term “caveat emptor.” “Caveat” in Latin means “let him beware.” “Emptor” is a purchaser, “faenerator” is a money-lender (often a userer), and “coactor” is a collector of money. Purchasers, lenders, and collectors all need to beware in the difficult economic times in which we find ourselves of unusual bargains, of obtaining sufficient collateralization, and of collecting debts. Each of these actions may implicate the avoiding powers of federal bankruptcy and state insolvency laws and well-counseled buyers, lenders, and collectors need to understand the potential risks and pitfalls of collections. A review of the basics of these concepts is helpful.

II. Fraudulent Transfers, Preferences, and Avoiding Powers

A. Avoiding Powers in Bankruptcy. Generally, the Bankruptcy Code provides an arsenal of avoiding powers to the trustee in bankruptcy (“TIB”) or the debtor in possession (“DIP”), who is given most of the rights of a TIB in Chapter 11 reorganization cases. These include avoidance of “preferences,” and “fraudulent transfers.” Under the so-called strong-arm provisions, the TIB is endowed with the powers and leverage of an ideal, hypothetical intervening lien creditor, a judgment creditor, a bona fide purchaser of real property, and virtually any avoiding power under state law. Why? Because equally placed creditors are to be treated equally and, if a creditor receives a benefit from the debtor within a certain period before bankruptcy, this policy of equal treatment is violated.

B. Fraudulent Transfers. The avoidance of fraudulent transfers dates to Roman times. Most scholars date fraudulent transfer analysis in Anglo-American law to 1570 with the Statute of 13 Elizabeth, but others have traced its origins to as early as 1376 in a statute enacted in the fiftieth year of Edward’s reign. The term “fraudulent transfer” sounds ominous. Under the Uniform Fraudulent Transfer Act (“UFTA”) and the older Uniform Fraudulent Conveyance Act enacted in some form by almost all the states, under Bankruptcy Code section 544(b), which gives a TIB or DIP the right to employ rights under UFTA, and under Bankruptcy Code section 548, fraudulent transfers can be set aside by a court for the benefit of creditors who were harmed by the transfer. There are two types of fraudulent transfer: one involving actual fraudulent intent and the other involving euphemistically-called “constructive” fraud.

1. Actual fraud. Since the Statute of 13 Elizabeth, the same language addressing actual fraud has been utilized: if a debtor engages in a transaction with “intent to hinder, delay, or defraud” its creditors, the transaction can be avoided as fraudulent. It is important to remember that it is not just actual intent to defraud, but also the intent to hinder or delay a creditor, although some court decisions quote “hindering,” “delaying,” and “defrauding” and require a showing of actual intent to defraud. Case law developed a wide-ranging list of “badges” of fraud because fraudulent intent was often difficult to prove directly. Courts still employ these badges of fraud in determining whether a transfer involves actual fraud.

2. Constructive fraud. Because it is often difficult to prove actual fraud, the concept of constructive fraud developed. For a transfer to be avoided as “constructively”

fraudulent, it must be proven that the debtor received less than “reasonably equivalent value” for its transfer and that the debtor was insolvent at the time of the transfer, was rendered insolvent by the transfer, or was left with “unreasonably small capital” following the transfer. The easiest example of a constructively fraudulent transfer is the transfer by one spouse to another or by a parent to a child of a significant asset such as a house when the transferring spouse or parent is insolvent or is rendered insolvent by the transfer. This is a classic fraudulent transfer and can be avoided under state or federal law if an action is commenced within the applicable statute of limitation.

3. Section 544(b). Under the so-called “strong-arm” powers of Section 544(b) of the Bankruptcy Code, the TIB can stand in the shoes of an unsecured creditor at state law to avoid transactions under state law. In Utah, the UFTA is the law. This is sometimes critical because state fraudulent transfer laws have much longer statutes of limitation than section 548’s two-year limit. A significant requirement is that the TIB likely must identify an actual creditor who was a creditor of the debtor at the time of the transfer who is still a creditor.

4. The rule in Moore v. Bay. Although under state law, an unsecured creditor can avoid a fraudulent transfer only to the extent of its damage (if it is owed \$1.00 it could avoid a \$1 billion fraudulent transfer only to the extent of \$1.00). Under the 1931 United States Supreme Court decision in Moore v. Bay, 284 U.S. 4 (1931), however, a TIB, standing in that same creditor’s place, can avoid the entire \$1 billion fraudulent transfer. The rule in Moore v. Bay continues to be good law and has been reiterated in recent circuit decisions such as In re Acequia, Inc., 34 F.3d 800 (9th Cir. 1994), and Coleman v. Community Trust Bank (In re Coleman), 426 F.3d 719 (4th Cir. 2005).

C. Preferences. The concept of avoiding preferential transfers grows out of the bankruptcy policy of equal treatment for equally-situated creditors. If one creditor received more than another, the transfer to the one should be avoided so that they can then be treated equally. With limited exceptions in a few states and under the UFTA in certain insider transactions, there is no state-law analogue for avoiding preferential transfers and these issues arise principally in federal bankruptcy cases.

1. Elements of an Avoidable Preference. Under section 547(b) of the Bankruptcy Code, an avoidable preference is a transfer of property of the debtor, to or for benefit of a creditor, on account of antecedent debt, made while the debtor was insolvent (insolvency is rebuttably presumed for the ninety days prior to bankruptcy), made within ninety days (or, if the preference recipient is an insider, within one year), that enables the creditor to receive more than it would have in Chapter 7. Each element of a preference must be found. If any of the elements is missing, the transfer is not avoidable. Transfers of property amounting to avoidable preferences can be payments by the debtor, but they can also be obtaining a security interest, perfecting a security interest, and obtaining a judgment.

2. Defenses to Preferences. Because of the significant imposition preference liability can be for an entity doing business with a financially distressed company, and to encourage companies to continue to do business with distressed companies, there are a

number of effective defenses to a preference action under section 547(c). Included most prominently among these defenses are the following.

a. Ordinary course. If a transfer was incurred and paid in ordinary course of business and in line with terms utilized in the industry, the transfer may not be avoidable.

b. Contemporaneous exchange. If the parties contemplated that they would make a substantially contemporaneous exchange and if, in fact, the transaction involved a substantially contemporaneous exchange, the transfer cannot be avoided as a preference.

c. New value. If, after receiving a transfer that would be a preference, the creditor advances new value to the debtor, its preference liability is reduced to the extent of the new value.

III. Application of Principles

Clever attorneys and trustee are limited only by ethical and legal constraints in finding transfers that should be avoided as fraudulent and preferential transfers. And clever creditor attorneys and analysts will find effective ways to respond and defend (and deride) causes of action brought by TIB's and DIP's. The list below is hardly exhaustive, but includes various common transfers that parties may seek to avoid under state or federal insolvency laws. These transfers only scratch the surface and do not address very fully potential defenses. Questions of what constitutes a transfer, what value should be applied to the transfer, who has standing to seek to avoid a fraudulent transfer, and other questions are all complicated and may provide relief to a transferee. These questions are also beyond the scope of these materials.

A. Fraudulent Transfers. Fraudulent transfer issues may arise in a number of contexts that you may not expect or at least initially consider. The discussion of various transactions that might be attacked as fraudulent transfers is not meant to suggest that there may not be effective responses and defenses to the allegations, depending on the parties, the individual facts, and the applicable law.

1. Overcollateralization. In a distressed lending, the lender may seek as much collateral as possible, particularly in a falling market. This could occur in a new lending relationship or it could occur in a renewal of a loan with the lender demanding additional collateral in exchange for additional collateral (or perhaps collateral in the first instance, if the loan has been unsecured). If the borrower defaults, the lender might pursue foreclosure or it might accept some type of transfer in lieu of foreclosure. If the lender ultimately obtains ownership of the property for the value of the loan made, the loan could be determined to be less than reasonable equivalent value in exchange for ownership of the property and it is very possible that the borrower either is already insolvent or that it may be rendered insolvent by the loss of the property.

a. Foreclosure Sales of Real Property and the BFP Decision. Prior to the United States Supreme Court's decision in BFP v. Resolution Trust Corporation, 511 U.S. 531 (1994), many decisions had followed the Fifth

Circuit's lead in Durrett v. Washington National Insurance Co., 621 F.2d 201 (5th Cir. 1980), by holding that a foreclosure under state law could be a fraudulent transfer if the debtor was insolvent at the time and the foreclosure resulted in less than reasonably equivalent consideration being provided. The Supreme Court ruled, however, that a real estate foreclosure regularly conducted under state law in which there is no collusion is presumptively not a fraudulent transfer.

b. Deeds in Lieu of Foreclosure and Sales of Personal Property. The BFP decision is limited to foreclosure sales of real property (or an equivalent such as a trustee's sale under a trust deed) and some court decisions have refused to extend it beyond this limited type of sale. Parties have argued that state regulatory approval for a substantial transaction such as the sale of the stock of a life insurance company involves the same public policy issues as a real property foreclosure sale, but courts have been reluctant even to accord consideration under a regulated sale to be presumed to be for reasonably equivalent value. A lender's acceptance of a deed in lieu of foreclosure when the property is worth substantially more than the lender is owed could be attacked as a fraudulent transfer. Also, although a lender secured by personal property is generally required to conduct a commercially reasonable sale of personal property collateral by UCC section 9-610, and a borrower may attack a sale if it is not commercially reasonable, a creditor or a TIB could also attack a sale of personal property collateral as a fraudulent transfer.

c. Other "Involuntary" Transfers. Transfers through foreclosure or execution are involuntary – that is, the debtor is not generally consenting to the sale of its assets. Other involuntary transfers, such as the termination of a favorable lease or termination of a management contract may be attacked as constructively fraudulent if the leasehold or contract rights are valuable to the debtor.

2. "Bargain" Purchases. The purchase of an old painting or book at a yard sale could conceivably be a fraudulent transfer, if it turns out that the item purchased is much more valuable than the consideration given for it. Most yard sale purchases are transactions involving property that is worth little and that would not give rise to fraudulent transfer litigation. The distressed sale of real estate may be a fraudulent transfer. In a business asset context, what if a company sells a valuable asset for less than equivalent consideration, even though the consideration is millions or tens of millions of dollars, because the company needs whatever funding it can receive. First, remember that the standard is not that the consideration be the fair market value for the purchased property, only that it has to be "reasonably equivalent." This is not an mathematical equation. One of the challenges, however, that can either work in favor of or against the interests of the purchaser, is establishing the value of a purchased item. Just as it may be difficult to assess the value of an old painting that turns out to be a long-lost work by a famous artist, it may be difficult to assess the value of a business asset or of the ownership of a business. If the value is difficult to assess, it may be difficult for a court to conclude that less than reasonably equivalent value was exchanged for the asset. If, on

the other hand, the value of the property simply was not assessed, a creditor or TIB may later argue more persuasively that the purchase was a fraudulent transfer.

3. Upstream and cross-stream transactions. Often a lender or a collector will demand that subsidiaries or affiliates or relatives pledge assets to secure a party's borrowing. Alternatively, the affiliate or relative may simply be called upon to agree to guarantee the borrower's debt. In so-called "upstream" and "cross-stream" transactions, the guarantor or third-party pledgor may receive little or no consideration. If the subsidiary is insolvent when it provides the guaranty or pledges collateral for its parent or affiliate, it is almost certainly a fraudulent transfer because it does not receive reasonably equivalent consideration for the guaranty or pledge of assets. On the other hand, if the guaranty or pledge is "downstream," that is, from a parent corporation for the benefit of a subsidiary, the transfer likely is not a generally avoidable as a fraudulent transfer because the improved value of the subsidiary theoretically improves the value of the parent's ownership of the subsidiary.

4. Settlements. Mutual releases in the context of a settlement may be attacked as constructively fraudulent if the debtor gives up valuable rights in its release of the other party. For example, if a debtor has a strong litigation case against a party but is forced to settle for little or no recovery because of its financial condition or its inability to continue paying the costs of the litigation, its release of the other party could well be a fraudulent transfer.

5. Leveraged Transactions. Although leveraged buyouts ("LBO") are structured in a number of alternative ways, most or all involve at least the following elements: a third-party lender loans money to a party acquiring ownership of a target entity, after buying the ownership, the acquirer pledges the assets of the acquired entity to secure repayment to the third-party lender. Such lenders may be banks or other more traditional lenders or they may be bondholders. In a typical LBO, a weakly capitalized subsidiary is created, borrows from the third-party lender, acquires ownership of the target entity, and merges the acquired entity into the subsidiary. The subsidiary then pledges its assets to secure repayment to the lender. Such a transaction does not effect a change to the acquired entity's assets (other than fully encumbering them), but it substantially increases the debts of the acquired company, though now a part of the acquiring dummy subsidiary. Clearly, the acquired company has not received any consideration, only its owners have received consideration. Because of the significantly increased leverage, such entities often fail and a question is whether its creditors can successfully bring a fraudulent transfer action against the acquiring entity or, more likely against the acquiring entity's parent.

6. Ponzi Schemes. We are all painfully aware of so-called Ponzi schemes. A promoter raises money with the promise of unusually high or, in some cases such as Bernie Madoff, unusually steady, returns. Often, there are assurances that the funds will be invested in certain kinds of lending that will somehow provide the basis for the high returns. Parties invest, receive extraordinary returns, continue investing, often not taking their profits out, simply rolling them over as new investments. The required trick is that the organizer of the Ponzi scheme needs to keep raising money, either from new investors or from old, particularly those who do not need their profits now and want to keep all

their funds invested at the high level they keep seeing on paper. Too often, there is no real investment. Sometimes, the promoter initially intends to take the raised funds and make creditworthy loans secured by solid collateral, but this appropriate approach degenerates as the promoter is unable to continue meeting the promised returns. Under 10th Circuit case law, virtually all transactions in a genuine Ponzi scheme are fraudulent transfers to the extent they exceed the amounts invested. See Sender v. Buchanan (In re Hedged-Investments Associates, Inc.), 84 F.3d 1286 (10th Cir. 1996). Almost any return to an investor in excess of his or her investment likely will have to be returned to a TIB or a federal receiver. Ponzi scheme returns may also be attached as preferences.

7. Securitization Transactions. At least one commentator has argued that the typical securitization transaction involving the creation of a “bankruptcy remote” special purpose entity to which the parent then transfers substantial assets to secure a substantial borrowing or raising of funds, may be a fraudulent transfer under the actual fraud concept because creditors may be hindered from recovering on their claims. Kenneth C. Kettering, Securitization and Its Discontents: The Dynamics of Financial Product Development, 29 Cardozo L. Rev. 1553, 1585-1601 (2008). Kettering’s view has been seriously attacked, including by Thomas E. Plank, Sense and Sensibility in Securitization: A Prudent Legal Structure and a Fanciful Critique, 30 Cardozo L. Rev. 617 (2008).

8. Loan Where Proceeds May Be Used by a Party other than the Borrower. A borrower may have a valuable asset in which there is substantial equity. The borrower wants to transfer proceeds to affiliates for purposes that have nothing to do with the borrower. The lender agrees that the borrower may transfer substantial portions if the loan proceeds to affiliates. The borrower receives little or no value from the loan. The borrower is rendered insolvent by its pledge of collateral to secure the loan. The lender knows or should have known that the borrower’s affiliates were going to use most of all of the funds for their own ends rather than for the borrower’s ends. The lender appears to be more interested in obtaining a significant loan fee than in doing due diligence about the borrower or to what purposes it intends to put the loan proceeds. The borrower’s TIB may well argue that the pledge of collateral is a fraudulent transfer.

B. Preferential Transfers. As noted earlier, the concept of preferential transfers is intended to further the bankruptcy policy of equal distribution to similarly-situated creditors. The notion is simply that unsecured creditors should all be treated the same, although, to encourage vendors and creditors to continue providing trade credit to a distressed debtor, Congress provided important defenses. The time periods chosen by Congress for investigation of transfers is 90 days for non-insiders and one year for insiders. The longer insider period assumes that insiders will have greater information regarding the debtor’s financial affairs. One of the requirements of a preference is that there be an “antecedent debt.” In the context of preferences, therefore, consideration is generally assumed and is not an issue as it is in the context of fraudulent transfers.

1. Tardy Perfection and the “Countryman Two-Step”. Some actions that do not seem like “transfers” are, in fact, transfers for purposes of avoidance of preferential transfers. Transfers do not need to be of money, they can be valuable rights, or of personal or real property. One of the atypical types of transfers is perfection of a security interest under state law. If a lender makes a loan to a debtor and receives a security

interest in collateral, the lender will need to perfect its security interest promptly. Perfection of the security interest is a transfer for purposes of preferential transfer analysis. If the secured party is tardy in filing its financing statement and ultimately files the financing statement within the 90 days before the debtor's bankruptcy filing, the perfection can be avoided under section 547 of the Bankruptcy Code. If the creditor is properly perfected and fully secured, payments made on the loan within the 90 days before bankruptcy cannot be avoided because the fully secured creditor is going to be paid in full in all events and will not receive more than it would in a Chapter 7 liquidation. Once the perfection is avoided, however, payments made to the creditor by the debtor within the preference period may be avoidable preferences and the creditor will have to find a defense to avoidance of the payments, such as ordinary course. This two-step process, of first avoiding the security interest and then recovering payments made is sometimes referred to as the "Countryman two-step," after Vern Countryman, long-time bankruptcy professor at Harvard, who wrote about the process. The moral is that it is important to perfect security interests promptly to avoid avoidance of the perfection.

2. The Undersecured Creditor and Payments in the Preference Period. The Bankruptcy Code divides an undersecured creditor's claim in two, the secured claim is equal to the value of the collateral securing the loan, the unsecured claim is equal to the rest of the amount owing to the creditor. Case law assumes that payments made to an undersecured creditor are applied to the unsecured portion of the claim and they can, therefore, be preferences. Supreme Court precedent has determined that regular payments on an installment loan are not preferences if paid in the ordinary course of business, but irregular payments on an installment loan may not be ordinary course. Thus, a creditor who thought it was secured and perhaps even believed that it was fully secured learns after being sued for avoidance of a preference that it owes payments made to it within 90 days before bankruptcy to a TIB as preferences.

3. Unsecured Loan Transformed into a Secured Loan. A lender may loan initially on an unsecured basis. As time passes, however, it recognizes that the debtor may be unable to repay the unsecured loan, so the lender asks for security in exchange for not pursuing collection of the unsecured debt. The debtor obliges and grants a security interest in collateral it owns. The grant of security may be a preference and the lender may need to count to 90 days before feeling comfortable that it will retain the security interest.

4. Deprizio – Dead and Buried? In Levit v. Ingersoll Rand Finance Corp. (In re V.N. DePrizio Constr. Co.), 874 F.2d 1186 (7th Cir. 1989), the Seventh Circuit ruled that, because payments made to a lender had the effect of eliminating guaranty liability of an insider, the court should apply the one-year insider look-back period to payments made to the non-insider lender because they benefited the insider. Congress responded by enacting amendments to Section 550 of the Bankruptcy Code, which governs recovery of avoided transfers that attempted to make clear that payments made to the non-insider more than 90 days before the debtor's bankruptcy filing could not be avoided. Payments to the creditor may be for the benefit of the insider guarantor (in fact, often are) and the TIB may be able to pursue a preference action against the guarantor for whose benefit the

payments were made. Several courts have ruled, however, that Deprizio lives on because all the amendments to Section 550 do is restrict “recovery” of the avoided transfer, they do not restrict avoidance of the transfer under section 547. Thus, if the transfer a tardy perfection of a security interest and an insider is benefited by the perfection of the transfer, there may be no need to “recover” the avoided property (the security for the loan) because the bankruptcy estate owns the property. Recovery of the avoided transfer is not necessary. See In re Williams, 234 B.R. 801 (Bankr. D.Or. 1999).

C. A Few Words About Recovery of Avoided Transfers. Typically, obtaining value from avoidance actions by a TIB or DIP involves two actions: avoidance of the transfer and recovery of the transferred property or the value of the transferred property. A fraudulent transfer or preference is avoided and the TIB then has to recover the property transferred or the value of it. Section 550 of the Bankruptcy Code governs from whom avoided transfers may be recovered. It provides that the TIB “may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property,” from the initial and subsequent transferees. The TIB may recover from the initial transferee but not from a subsequent transferee “who takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided.” 11 U.S.C. § 550(a) and (b). Under section 9 of the UFTA, a creditor may not recover even from an initial transferee of an intentionally fraudulent transfer if the transferee acted in good faith and provided reasonably equivalent value.