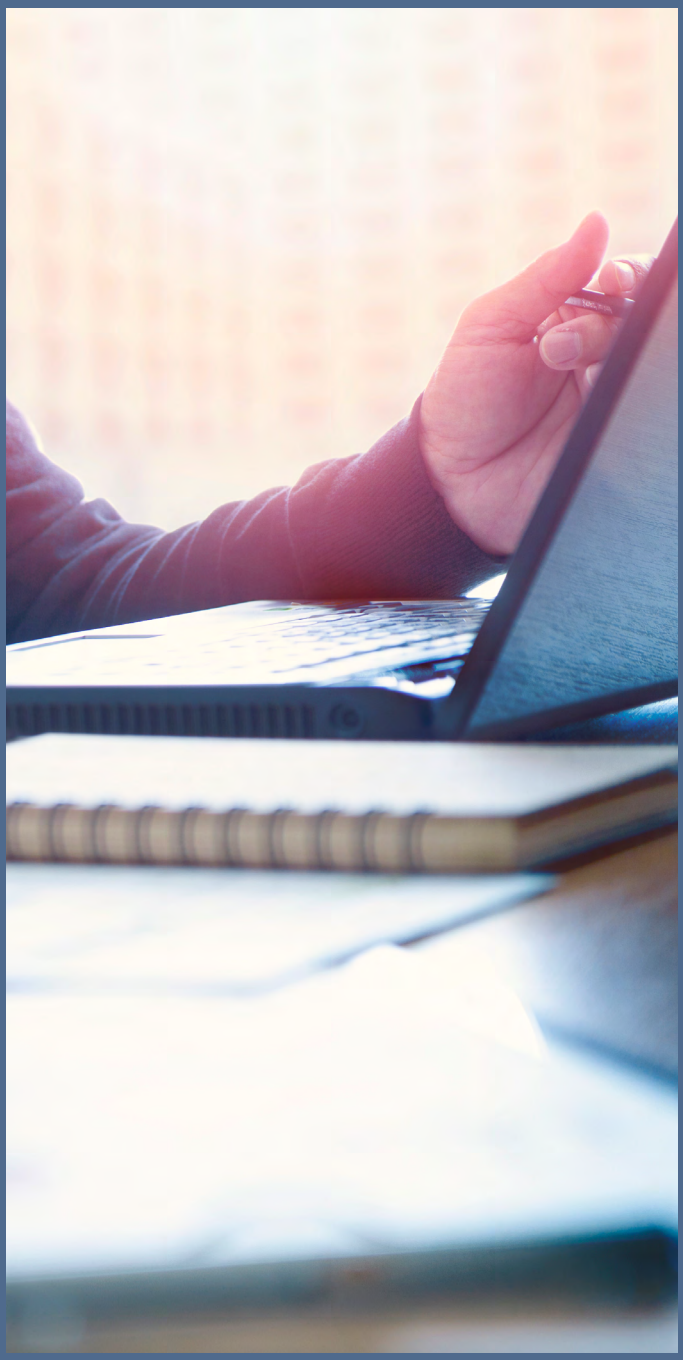

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PERSPECTIVES

Analysis of Fraudulent Conveyance Actions

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Disputes over allegedly fraudulent conveyances have become more common in bankruptcy cases. Fraudulent transfer allegations are also common in transactions such as leveraged buy-outs and recapitalizations. Analysts are frequently asked to provide expert opinions in these actions for trustees, debtors-in-possession, creditors, and other third-party plaintiffs. The law in this area is contained in the United States Bankruptcy Code and is centered around the avoidance powers granted to trustees and other relevant parties, specifically Section 548 fraudulent transfers and obligations. Generally, the analysis of fraudulent conveyances involves the determination and testing of whether a transfer meets the criteria of either actual or constructive fraud.

This discussion summarizes these criteria and describes some of the relevant tests conducted in fraudulent conveyance analyses. This discussion also summarizes possible "badges of fraud" analysis often applied to prove fraudulent intent in conveyance actions. Finally, this discussion should assist the reader (whether an analyst, trustee, counsel, plaintiff, creditor, or debtor-in-possession) in better understanding the complexities and requirements of fraudulent conveyance actions.

INTRODUCTION

Analysts are often called on to perform analyses and to issue expert opinions related to allegedly fraudulent conveyances (also known as fraudulent transfers). Such actions generally occur in a bankruptcy context and address the issues described in the United States Bankruptcy Code ("Code").

The plaintiff is often a trustee, debtor-in-possession ("DIP"), or creditor of the estate. The plaintiff alleges that but for certain fraudulent transfers, the creditors would have collected more of its outstanding debts. The defendants are either the estate or the trustee who either approved or did not set aside the allegedly fraudulent conveyance.

The primary purpose of the trustee in a bankruptcy setting is the fair and efficient administration of the estate. The Code outlines the many duties and powers of the trustee. In order to assist the trustee to fulfill his or her duties, bankruptcy law provides the power to set aside or "avoid" certain asset transfers from the estate.

For example, if a debtor transferred estate assets to a third party with the intent to defraud its creditors, then the transfer may be categorized as a fraudulent conveyance. In this instance, the trustee may, with the bankruptcy court's approval, set aside the conveyance. Alternatively, a third-party creditor of the estate may sue the estate seeking the avoidance of the allegedly fraudulent transfer.

Bankruptcy law differentiates fraudulent conveyances as either actual fraud or constructive fraud. Actual fraud focuses on the "actual intent to hinder, delay, or defraud" creditors of the estate. As one may imagine, proving intent is a difficult proposition for many trustees and creditor plaintiffs seeking recovery in bankruptcy court. Various state and federal courts have accepted the use of "badges of fraud" analyses to assist in proving intent in these matters.

Constructive fraud focuses on transfers where the estate received "less than reasonably equivalent value" in exchange for the transfer. Such a transfer may be considered a fraudulent conveyance if the debtor:

1. is insolvent,
2. is unable to pay its debts as they became due, or
3. has unreasonably small capital on the transfer date.

Multiple analytical dilemmas exist in these scenarios. The most important of which is that the Code is silent on the definition of "reasonably equivalent value."

The purpose of the analyst's expert opinion is the determination of whether the transfer(s) in question meet the qualifications of either actual or constructive fraud. These analyses may be prepared for the plaintiff, defendant, or as a neutral in an arbitration setting. If the court determines the transfer was a fraudulent conveyance, the trustee may recover the property (avoid the transfer) as part of the estate.

The following summarizes the Code and related law for fraudulent conveyances. It also addresses the tests which may be performed by the analyst in a fraudulent conveyance analysis. Note that much of this discussion assumes the trustee fills the role of plaintiff in the dispute over whether the transfer is fraudulent. In reality, the DIP or third-party creditor may also fill this role.

ROLES AND RESPONSIBILITIES OF THE TRUSTEE

The Code assigns a host of duties to the bankruptcy trustee. These duties are specified in Code Section 704, with the relevant sections summarized as follows:

11 U.S. Code Section 704: Duties of Trustee

(a) The trustee shall—

1. collect and reduce to money the property of the estate for which such trustee serves, and close such estate as expeditiously as is compatible with the best interests of parties in interest;
2. be accountable for all property received;
3. ensure the debtor shall perform his intention related to property securing consumer debt;
4. investigate the financial affairs of the debtor;
5. if a purpose would be served, examine proofs of claims and object to the allowance of any claim that is improper;
6. if advisable, oppose the discharge of the debtor;
7. unless the court orders otherwise, furnish such information concerning the estate and the estate's administration as is requested by a party in interest;
8. if the business of the debtor is authorized to be operated, file with the court, with the United States trustee, and with any governmental unit charged with responsibility for collection or determination of any tax arising out of such operation, periodic report and summaries of the operation of such business, including a statement of receipts and disbursements, and such other information as the United States trustee or the court requires;
9. make a final report and file a final account of the administration of the estate with the court and with the United States trustee.

A reader of the above duties may be surprised that there is no mention of any fiduciary obligation of the trustee to the creditors. While outside the scope of this discussion, fiduciary law suggests that the trustee has obligations to the various classes of creditors, although possibly in varying degrees.

For example, the duty to "collect and reduce to money the property of the estate" has been interpreted by courts as a fiduciary role. More relevant to this discussion are the powers granted to the trustee and how the trustee may wield those powers.[1]

In addition to the trustee's ability to hire experts, obtain financing, acquire, and/or sell assets, the Code provides the trustee with significant avoidance powers. These powers are detailed in Code Sections 544, 545, 547, 548, and 549.

While the following is not an exhaustive analysis of the trustee's powers, it will provide the reader with a general understanding of the trustee's avoidance powers, and more specifically, how the trustee may avoid fraudulent conveyances. The latter is the focus of this discussion and is detailed in Section 548, Fraudulent Transfers and Obligations.

CODE PROVISIONS FOR FRAUDULENT CONVEYANCES

Section 544(a) is sometimes referred to as the "strong-arm clause" and provides the trustee the rights of a judicial lien creditor or a purchaser of real estate. Section 544(b) grants powers like those of an unsecured creditor.

[1] See generally John A.E. Pottow, "Fiduciary Duties in Bankruptcy and Insolvency," The Oxford Handbook of Fiduciary Law (University of Michigan, March 29, 2018).

11 U.S. Code Section 554: Trustee as Lien Creditor and as Successor to Certain Creditor and Purchasers

(a) The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—

1. a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;

2. a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists; or

3. a bona fide purchaser of real property, other than fixtures, from the debt-or, against whom applicable law permits such transfer to be perfected, that obtains the status of bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists.

(b)

1. Except as provided in paragraph (2), the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title.

2. Paragraph (1) shall not apply to a transfer of a charitable contribution (as that term is defined in section 548(d)(3)) that is not covered under section 548(a)(1)(B), by reason of section 548(a)(2).

   Any claim by any person to recover a transferred contribution described in the preceding sentence under Federal of State law in a Federal or State court shall be preempted by the commencement of the case.

11 U.S. Code Section 545: Statutory Liens

The trustee may avoid the fixing of a statutory lien on property of the debtor to the extent that such lien—

1. first becomes effective against the debtor—

   (A) when a case under this title concerning the debtor is commenced;

   (B) when an insolvency proceeding other than under this title concerning the debtor is commenced;

   (C) when a custodian is appointed or authorized to take or takes possession;

   (D) when the debtor becomes insolvent;

   (E) when the debtor's financial condition fails to meet a specified standard; or

   (F) at the time of an execution against property of the debtor levied at the instance of an entity other than the holder of such statutory lien;

2. is not perfected or enforceable at the time of the commencement of the case against a bona fide purchaser that purchases such property at the time of the commencement of the case, whether or not such a purchaser exists, except in any case in which a purchaser is a purchaser described in section 6323 of the Internal Revenue Code of 1986, or in any other similar provision of State or local law;

3. is for rent; or

4. is a lien of distress for rent.

Section 547 allows the trustee to avoid certain preference payments within 90 days of the petition date.

11 U.S. Code Section 547 – Preferences

(b) Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property

1. to or for the benefit of a creditor;
2. for or on account of an antecedent debt owed by the debtor before such transfer was made;
3. made while the debtor was insolvent;
4. made—

   (A) on or within 90 days before the date of the filing of the petition; or

   (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

5. that enables such creditor to receive more than such creditor would receive if

   (A) the case were a case under chapter 7 of this title;

   (B) the transfer had not been made; and

   (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

Section 548 allows the trustee to avoid certain fraudulent transfers and differentiates transfers based on intent. Section 548(a)(1)(A) states that any transfer made within two years before the petition date, whether made voluntarily or involuntarily, may be set aside if such transfer was made with the actual intent to hinder, delay, or defraud any creditor.

Section 548(a)(1)(B) states that any transfer made within two years before the petition date, whether made voluntarily or involuntarily, may be set aside if the estate received less than a reasonably equivalent value in exchange for the transfer and either:

1. The estate was insolvent,
2. The property remaining with the debtor was unreasonably small capital,
3. The debtor incurred debts that would be beyond the debtor's ability to pay, or
4. Transfer was to or for the benefit of an insider.

11 U.S. Code Section 548 – Fraudulent Transfers and Obligations

(a)

1. The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract)of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—

   (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

   (B)
   (I) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

   (II)
   (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

   (II) 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 an unreasonably small capital;

(III) 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; or

(IV) made such transfer to or for the benefit of an insider or incurred such obligation to of for the benefit of an insider, under an employment contract and not in the ordinary course of business.

Section 549 allows the trustee to avoid certain transactions subsequent to the petition date.

11 U.S. Code Section 549 – Post-petition Transactions

(a) Except as provided in subsection (b) or (c) of this section, the trustee may avoid a transfer of property of the estate—

1. that occurs after the commencement of the case; and
2.
   (A) that is authorized only under section 303(f) or 542 (c) of this title; or

   (B) that is not authorized under this title or by the court.

FRAUDULENT CONVEYANCE LITIGATION

Thus far this discussion has focused on the powers of the trustee and the circumstances under which the trustee may avoid certain types of transfers. In these instances, the trustee avoids or sets aside the transfer (after proving the requirement of the case to the appropriate court) and the assets are returned to the estate.

In other situations, the trustee or the DIP administering the estate neglects to avoid the fraudulent transfer. Such events may lead to litigation against the estate, the trustee, or the DIP by one or more creditors of the estate.

It is common practice for counsel for estates, trustees, and DIPs to retain analysts to examine allegedly fraudulent conveyances and to provide expert opinions in bankruptcy and other courts. These analyses generally begin with an examination of Code Section 548.

The Code differentiates fraudulent transfers as either actual fraud or constructive fraud. The former assumes actual intent by the estate to hinder, delay, or defraud one or more creditors of the estate. Therefore, the plaintiff in any fraudulent conveyance action claiming actual fraud will be burdened with the proof of intent. Since intent is a difficult to prove, the courts have accepted various versions of "badges of fraud" to aid this analysis. Further discussion of the badges of fraud is presented below.

Alternatively, claims for constructive fraud do not require proof of intent. Rather constructive fraud requires that the estate received less than a reasonably equivalent value in exchange for the transfer along with one of four additional requirements.

First, the estate was insolvent on the date of the transfer or became insolvent because of the transfer. Second, the estate retained unreasonably small capital subsequent to the transfer. Third, the estate was unable to pay debts as they became due because of the transfer. Fourth, the estate made the transfer for the benefit of an insider.

The analyst may provide expert opinions on whether the transfer meets any or all of the criteria of fraudulent conveyances as of the time of the specific transfer. Limitations for both actual and constructive fraud claims for fraudulent conveyances are within two years prior to the bankruptcy petition date.

There are additional exemptions noted in Section 548 addressing transfers to qualified religious and charitable entities that are beyond the scope of this discussion.
Finally, any analysis should consider state law variances. For

example, a majority of states utilize the guidelines contained in the Uniform Fraudulent Transfer Act ("UFTA") while others govern by the Uniform Fraudulent Conveyance Act (New York and other states). The UFTA was approved and adopted in 1984 by the Uniform Law Commission ("ULC"). In 2014, the ULC made modifications to the UFTA and renamed it the Uniform Voidable Transactions Act ("UVTA").

The UVTA is largely the same as the UFTA. The purpose of each of these acts is to prevent estates from fraudulently transferring assets in order to avoid current or anticipated claims by creditors.

ACTUAL FRAUD

The analysis of actual fraud is based on whether the estate made the transfer with the actual intent to hinder, delay, or defraud its creditors. As the proof of intent would require the reading of the perpetrator's mind, the courts rely on circumstantial evidence of fraud.

Since Twyne's Case, [2] courts have used various badges of fraud analyses as a tool to determine intent. In 2014, the UVTA codified 11 badges of fraud for consideration.

While different courts may assign different weights to each factor (or no weight at all), the following list of factors is a useful tool for the analyst to consider in fraudulent conveyances matters:

1. **The transfer or obligation was to an insider.** Transfers to close family members, business associates, of corporate entities with similar ownership or board membership may receive scrutiny from the courts.

2. **The debtor retained possession or control of the property transferred after the transfer.** Joint ownership or actual control over transferred assets may signal intent to hinder, delay, or defraud creditors.

3. **The transfer or obligation was undisclosed or concealed.** Collusion between parties may be a significant indicator of fraud.

4. **Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit.** If the relevant transfer is made at, or about, the time litigation is threatened or initiated, fraud may be present.

5. **The transfer was substantially all the debtor's assets.** The sale of a substantial portion of the debtor's assets at less than fair value may indicate intent.

6. **The debtor absconded.** Transfers made hurriedly and secretly may signal intent to hinder, delay, or defraud creditors.

7. **The debtor removed or concealed assets.** The movement of assets outside the ordinary course of business or the hiding of assets may be an indicator of fraud.

8. **The value of the consideration received by the debtor was not reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred.** The reasonably equivalent standard is generally used with other badges as a basis for fraud.

9. **The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred.** Insolvency is a frequent badge in fraud in fraudulent conveyances, especially when other badges are present. Solvency tests are addressed later in this discussion.

10. **The transfer occurred shortly before or shortly after a substantial debt was incurred.** Transfer made at or near the time of incurred debts (and for similar amounts) may be a signal of fraud.

11. **The debtor transferred the essential assets of the business to a lienor that transferred the assets to an insider of the debtor.** Collusion between parties may be a significant indicator of fraudulent intent.

The above list of the badges of fraud should not be considered exhaustive. State and federal courts continually update badges of fraud to deal with more complex fraudulent activity.

[2] Twyne's Case, 76 E.R. 809 (Star Chamber, 1601).

CONSTRUCTIVE FRAUD

The analysis of a constructive fraud claim is based on whether the estate received reasonably equivalent value for the transfer. Unfortunately, the Code neither defines nor provides a formula for the computation of reasonably equivalent value.

If nothing of value is exchanged for the transfer, the analysis is straightforward and demonstrates that the transfer meets the standard of constructive fraud. In more complex cases, assets like cash or marketable securities may be exchanged for less liquid assets such as intellectual property (patents, trademarks, and copyrights), debt instruments, or real estate.

The trustee or DIP should then prove that the values are (1) not equivalent and (2) not reasonably equivalent.

While a detailed analysis of the reasonably equivalent value concept is beyond the scope of this discussion, the reader should understand that the courts make such determinations on a case-by-case basis and evaluate the merits based on the cumulative facts of the case. The main concern of the court will be whether there was harm to the creditors of the estate.

Assuming the analysis demonstrates the estate received less than reasonably equivalent value, the next step is the analysis of the following four tests to determine if a fraudulent conveyance occurred.

First, was the estate insolvent on either the date of transfer or immediately subsequent to the transfer? Solvency is analyzed using the balance sheet test. If the fair value of the assets is greater than the fair value of the liabilities, the estate passes the balance sheet test.

Second, subsequent to the transfer, did the estate possess unreasonably small capital? This is analyzed using the capital adequacy test (also referred to as the "reasonable capital test").

If in the short term (generally one year or the operating cycle), the estate has capital sufficient to meet its operating expenses, capital expenditure requirements, and debt payment obligations, the estate passes the capital adequacy test.

Third, did the estate possess the ability to pay its debts as they become due? The ability to pay debts is analyzed using the cash flow test. If the estate can pay its projected obligations from excess cash at the transfer date, from cash flow generated during the projection period or from unused credit facilities, the estate passes the cash flow test.

And finally, was the transfer to or for the benefit of an insider? Context is necessary to determine whether the recipient is an insider. For instance, for an individual debtor, an insider may be an immediate or close family member. In a corporate estate, an insider may be a board member or senior executive. Transfers in the ordinary course of business are generally exempt from this category. If the transfer is not to an insider, the estate passes the insider test.

If the estate received less than a reasonably equivalent value for the transfer and failed any of the four tests noted above, the trustee or DIP may ask the court to consider the transfer fraudulent and set the transfer aside.

In the Winter 2014 issue of Insights,[3] Gilbert and Wishing presented a detailed discussion of the balance sheet, capital adequacy, and cash flow tests. Additionally, they presented a procedural and due diligence checklist that may be useful to analysts and other users of fraudulent conveyance opinions.

CONCLUSION

Fraudulent conveyance actions are complex and are in no way assisted by the vague language contained in the United States Bankruptcy Code. Prior to becoming involved in a fraudulent conveyance case, the analyst should gain a general understanding of the relevant bankruptcy law and avoidance powers of the trustee along with a specific understanding of Section 548, Fraudulent Transfers and Obligations.

The analyst's first step is to examine the allegedly fraudulent conveyance and determine whether the transfer meets any of the conditions of either actual or constructive fraud. If conditions exist that make the transfer appear to hinder, delay, or defraud one or more of the estate's creditors, the analyst may perform a badges of fraud analysis to determine fraudulent intent.

[3] Katherine Gilbert and Kyle Wishing, "Due Diligence and Analytical Procedures for Fraudulent Conveyance Opinions," Willamette Management Associates Insights (Winter 2014).

Fraudulent intent is required to prove actual fraud. Courts have used such analysis to avoid fraudulent conveyances with as few as one badge of fraud in existence. Multiple badges may significantly strengthen the fraud case.

If the circumstances surrounding the allegedly fraudulent transfer do not meet the criteria for actual fraud, the analyst's next step is to analyze the tests of constructive fraud.

The analyst determines whether the estate received less than reasonably equivalent value for the transfer. If so, the analyst may also conduct solvency (balance sheet), capital adequacy, and cash flow tests. Finally, the analyst determines whether the transfer was to an insider. The failure of any of these tests may indicate the existence of a fraudulent conveyance.

Once a determination of either actual or constructive fraud is made, the plaintiff (trustee, DIP, or creditor) may seek avoidance of the transfer and recovery of either the asset or compensation to the trust. The plaintiff may also obtain an injunction against future asset disposals.

Finally, the client should understand the complexities and difficulties of proving fraudulent conveyances before undertaking such actions. In many instances, the analyst can assist the client and respective counsel in determining whether the facts and circumstances of the case might support either actual or constructive fraud claims under Section 548.

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REFERENCES

1. See generally John A.E. Pottow, "Fiduciary Duties in Bankruptcy and Insolvency," The Oxford Handbook of Fiduciary Law (University of Michigan, March 29, 2018).

2. Twyne's Case, 76 E.R. 809 (Star Chamber, 1601).

3. Katherine Gilbert and Kyle Wishing, "Due Diligence and Analytical Procedures for Fraudulent Conveyance Opinions," Willamette Management Associates Insights (Winter 2014).