FRAUDULENT TRANSFERS[1]

Avoidence of fraudulent transfers differs from avoidance of preferences. Preferences represent legitimate payments honestly owed; a fraudulent transfer generally is viewed as one that skews the division of property among creditors and wrongfully depletes the estate—although such is not always the case. While preference avoidance aims to ensure that all unsecured creditors are treated equally, the avoidance of fraudulent transfer focuses on the relationship between the debtor and the creditor.

I. Fraudulent Transfers: Section 548

A bankruptcy trustee can recover fraudulent transfers and obligations in a bankruptcy proceeding pursuant to 11 U. S. C. §548 or state fraudulent transfer laws.

Section 548(a) gives the trustee the power to avoid a transfer, or any obligation incurred by the debtor, that was made or incurred on or within two years before the date of the filing of the petition if the debtor voluntarily or involuntarily made such transfer or incurred such obligation through either actual fraud or constructive fraud.

A. Actual Fraud - 11 U.S.C. 548(a)(1)(A).

If the trustee is proceeding under § 548(a)(1)(A), the trustee must prove actual intent to hinder, delay or defraud any entity to which the debtor was or became, on or after the date that such transfer occurred or such obligation was incurred or indebted. There is a split of authority whether the trustee must show intent by clear and convincing evidence or merely by a preponderance of the evidence. *See In re C.F. Foods, LP*, 280 B.R. 103, 111 (Bankr. E.D. Pa. 2002) (and cases cited therein). Since it is unlikely that there will be direct evidence of fraudulent intent, it usually must be proved by circumstantial evidence. Further intent to defraud need not be proved; instead, intent to hinder or delay is sufficient. The intent can be that of either the transferee or debtor, and the transferee's intent may be imputed to the debtor if the transferee is in a position to control the debtor. To prove actual intent, the trustee can use the presumption that one intends the legal consequences of his acts as well as the "badges of fraud" that have been employed since the Statute of Elizabeth [1571], and a form of which presently are enacted under North Carolina law in the Uniform Fraudulent Transfer Act, N.C.G.S. § 39-23.4(b). *See e.g,. Whitaker v. Mortgage Miracle, Inc. (In re Summit Place, LLC),* 298 R.R. 62 (W.D.N.C. 2002). The traditonal badges of fraud include: (1) a transfer of all of the debtor's property; (2) a transfer of title but retention of possession by the debtor; (3) a secret conveyance; (4) a trust relationship between the debtor and transferee; (5) a conveyance during pending litigation; (6) the instrument itself suspiciously refers to the transfer as bona fide; (7) inadequate consideration; and (8) a gift to family member. *See Twyne's Case*, 3 Coke 80b, 76 Eng. Rep. 809 (1601).

The North Carolina Uniform Fraudulent Transfer Act, N.C.G.S. § 39-23.4(b), states that the following factors also may be considered when determining the existence of fraudulent intent:

(1) The transfer or obligation was to an insider;
(2) The debtor retained possession or control of the property transferred after the transfer;
(3) The transfer or obligation was disclosed or concealed;
(4) Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
(5) The transfer was of substantially all the debtor's assets;
(6) The debtor absconded;
(7) The debtor removed or concealed assets;
(8) The value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

(9) The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
(10) The transfer occurred shortly before or shortly after a substantial debt was incurred;
(11) The debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor;
(12) The debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor reasonably should have believed that the debtor would incur debts beyond the debtor's ability to pay as they became due; and
(13) The debtor transferred the assets in the course of legitimate estate or tax planning.

N.C.G.S. § 39-23.4(b).

Other circumstances that would be indicative of actual fraud include a transfer under false pretenses, failure to record a conveyance document normally recorded, placing proceeds in a secret bank account, satisfaction of an already forgiven debt, and formation of a new corporation to receive the transfer.

Generally more than one indicia of fraud is required to sustain a showing of fraudulent intent. “While each fact does not have to demonstrate actual fraud, the facts taken together must lead to the conclusion that actual fraud existed.” *Harman v. First Am. Bank of Md. (In re Jeffrey Bigelow Design Group, Inc.*), 956 F.2d 479, 483-484 (4th Cir. 1992)(citing 4 *Collier on Bankruptcy*, ¶548.02[5](15th ed. 1989)). Once the trustee has introduced evidence proving fraudulent intent, the burden shifts to the defendant to negate the proof of intent by satisfactory explanation.

Note that claims to avoid fraudulent transfers under §548(a)(1)(A) are subject to the heightened pleading standard under Rule 9(b) of the Federal Rules of Civil Procedure as made applicable to bankruptcy cases under Rule 7009 of the Federal Rules of Bankruptcy Procedure. See *In re Devrium Capital, LLC*, 380 B.R. 429, 439 (Bankr. D.S.C. 2006)(citing *In Re Verestar, Inc*. 343 B.R. 444 (Bankr. S.D.N.Y. 2006)). Thus, a party alleging fraud must “state with particularity the circumstances constituting fraud.” FED. R. CIV. P. 9(B); FED. R. BANKR. P. 7009. However, “malice, intent, knowledge and other conditions of a person’s mind may be alleged generally.” *Id.*

B. <u>Constructive Fraud – 11 U.S.C § 548(a)(1)(B).</u>

In recognition of the difficulty of proving something as subjective as actual intent, the Bankruptcy Code provides a cause of action based on constructive fraudulent intent.

11 U.S.C. § 548(a)(1)(B) provides that a conveyance is deemed fraudulent if the debtor received less than a reasonably equivalent value in exchange for the transfer; and the debtor either:

(i) was insolvent or became insolvent as a result of the transfer;

(ii) is engaged in a business which will have unreasonably small capital to conduct business after such transfer;

(iii) incurred debts beyond his or her ability to pay as the debts mature; or

(iv) the debtor made the transfer to an insider, or incurred an obligation for the benefit of an insider, pursuant to an employment contract entered into outside the ordinary course of business.

Highly leveraged buyout transactions can fall prey to avoidance under 11 U.S.C. § 548 because of the illusory nature of the consideration given by the buyer**.** *In re Bonds Distributing Co., Inc.*, 2000 WL 33673768, at *13-*14 (Bankr. M.D.N.C. 2000) (Stocks, J.) (collecting cases from various courts, including the Third Circuit Court of Appeals, that have held that leveraged buyouts may be characterized as fraudulent transfers). More recently, the Seventh Circuit in *Boyer v. Crown Stock Distribution Inc., et al*, 587

F3d 787 (7th Cir. 2009) agreed underscoring the court's ability to collapse the separate transactions of a LBO into one single transaction for the purposes of a fraudulent conveyance analysis. There the trustee was able to recover dividends paid from the LBO to the shareholders.[According to a *Wall Street Journa*l article, *At Tribune, Battle Expands*, dated April 19, 2011, creditors are planning to take similar action in the *Tribune* case seeking to recover in excess of $8 billion from shareholders who received dividends as a result of Sam Zell's buyout of the paper in the year prior to its bankruptcy filing.]

Although most actions have targeted shareholders in the LBO fraudulent conveyance context, lenders that were or are parties to LBOs should be aware of potential fraudulent conveyance claims as well. At least two courts have allowed such claims to proceed against lenders. *See e.g,. OODC LLC v. Majestic Management Inc. (In re OODC LLC*), 321 B.R. 128 (Bankr. D. Del. 2005); *Crowthers McCall Pattern Inc. v. Lewis*, 129 B.R 992 (S.D.NY. 1991). In *Crowther,* the court held that "a lender is required to make a reasonable determination that the buy out is consistent with the rights of creditors before advancing funds." *Id*. at 998. The court further noted that when a plaintiff alleges "that the lenders knew that …[the debtor] would not receive the loan proceeds but nevertheless assume responsibility for repaying the debt, and… that the eventual insolvency and bankruptcy of [the debtor]… was a foreseeable result of the [LBO]… the plaintiff has adequately pleaded a cause of action for fraudulent conveyance…." *Id*.

C. Defenses and/or Issues of Proof with Respect to an Alleged Fraudulent Transfer

Each of the elements of a fraudulent transfer present evidentiary problems for the party seeking avoidance.

1. Reasonably Equivalent Value

The phrase "reasonably equivalent value" is not defined in the Bankruptcy Code and the courts have struggled with this term. In *Peltz v. Hatten*, the court suggested that courts "examine the totality of circumstances" to ascertain whether the transaction at issue "conferred realizable commercial value to [the transferor that was] reasonably equivalent to the realizable commercial value of the assets transferred…." 279 B.R. 710, 736 (D.Del. 2002), aff'd 60 Fed. Appx. 401 (3d Cir. 2003)(internal quotations omitted). A host of factors should be considered including the good faith of the parties, the difference between the amount paid and the fair market value, and whether the transaction was at arm's length. Id. at 736-737.

Section § 548(d)(2)(A) defines "value" to be "property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor." Whether or not the actual value exchanged is "reasonably equivalent" is a question of fact.

The problem of valuation can be handled several ways. If the transfer was to satisfy or secure a debt, it is the amount of the debt. If the transfer was of tangible or intangible property with a present fair market value, it is that fair market value as established, for example, by standard published sources. Intangibles such as non-termination of a contract or forbearance from such may be measured as the profits to be earned under the contract or possible damages in the potential suit.

Also, a transferee or obligee who gives value in good faith has a lien on the property so transferred pursuant to 11 U.S.C. § 548(c). Thus, where the trustee is proceeding under 11 U.S.C. § 548(a)(2)(B), and where the recipient of the transfer from the debtor gives value in exchange for the transfer, the result of 11 U.S.C. § 548(c) is that the trustee either will not be able to avoid the transfer to the extent of the value transferred to the debtor, or that the transferee will have a lien in such property to the extent of the value transferred. Where a non-initial transferee takes for value and without knowledge of the voidability of the initial transfer, there can be no recovery from such transferee. *See* 11 U.S.C. § 550(b).

Particularly important in the real estate and foreclosure context is the United States Supreme Court case *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994), wherein the Court held that the price received at a

foreclosure sale conclusively establishes "reasonably equivalent value" of the mortgage property, as long as the requirements of state foreclosure law were met.

2. Insolvency

As with preferences, the debtor or trustee must prove insolvency. However, the debtor or trustee is not entitled to the benefit of the presumption of insolvency as with a preference. *See* 11 U.S.C. § 547(f). As noted above, the Bankruptcy Code defines insolvency to be a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of [fraudulent conveyances and exempt property]." 11 U.S.C. § 101(32) This requires a balance sheet analysis (i.e., assets vs. liabilities) and generally is not difficult to prove. The insolvency requirement will be met if the debtor was insolvent before the conveyance or as a result thereof.

3. Unreasonably Small Capital

The vagueness of this element works to the advantage of a creative attorney. The transferring debtor must have had some capital and disposed of something that left an unreasonably small amount to meet existing or anticipated needs. The debtor's financial statement should be examined, as well as other business records. A transaction that drastically reduces capital is highly suspect, as is any leveraged acquisition, such as a leveraged buyout. Unreasonably small capital may be established by evidence that indicates that the debtor was delinquent in paying bills or that its business continued under financial risk.

4. Intent to Incur Debts Beyond Ability to Pay

The main obstacle in proceeding under 11 U.S.C. § 548(a)(2) is proving that the debtors' intent to incur debts beyond its ability to pay as they mature was contemporaneous with the conveyance. Although a general intent is sufficient (as opposed to intent with respect to particular debts), it must have been present at the time of the conveyance. The subsequent bankruptcy itself may be evidence of the debtor's incurring debts beyond his or her present ability to pay unless the bankruptcy was caused by some intervening event, as the debtor is presumed to intend the reasonable consequences of his acts. Other large or unusual obligations should be considered to develop a pattern of behavior from which the intent can be inferred.

II. State Fraudulent Conveyance Law.

A. North Carolina.

North Carolina adopted the Uniform Fraudulent Transfer Act (UFTA) in 1997. The UFTA has the following effect:

a. All transfers made with actual intent to hinder, delay or defraud are deemed to be fraudulent. Intent is a question of fact and circumstantial evidence may be used to show the requisite intent.

b. A transfer is not voidable against a person who took in good faith and for a reasonably equivalent value.

c. Transfers are voidable as to existing and future creditors if they are made without reasonably equivalent value.

d. A transfer is fraudulent if not made for a reasonably equivalent value while the debtor is insolvent.

e. A cause of action similar to a bankruptcy preference action is created by declaring fraudulent a transfer made by an insolvent debtor to an insider for an antecedent debt, if the insider knew of the debtor's insolvency.

Under the UFTA, transfers made with fraudulent intent are subject to attack until four years after the transfer or one year after it was reasonably discovered, whichever is later; transfers made for inadequate consideration are subject to attack for a period of four years.

B. South Carolina

South Carolina has not adopted the UFTA and still relies on the Statute of Elizabeth. S.C. Code § 27-23-10.

For existing creditors, conveyances can be set aside as fraudulent transfers under South Carolina's Statute of Elizabeth under two conditions:

> (1) where the transfer is made by the grantor with the actual intent of defrauding his creditors where that intent is imputable to the grantee, even though there is a valuable consideration; and
>
> (2) where a transfer is made without actual intent to defraud the grantor's creditors, but without valuable consideration.

See, In re Ducate, 369 B.R. 251 (Bankr.D.S.C. 2007); *Albertson v. Robinson,* 371 S.C. 311, 638 S.E.2d 81(S.C.App. 2006), *rehearing denied*.

Under South Carolina law, subsequent creditors may have conveyances set aside as fraudulent as to creditors where: (1) conveyance was "voluntary," in sense that it was without consideration; and (2) it was made with view to future indebtedness or with actual fraudulent intent on part of grantor to defraud creditors. *In re Ducate* 355 B.R. 5 (Bankr.D.S.C. 2006)

III. Criminal Considerations.

A fraudulent transfer may expose the debtor and/or his attorney to criminal liability:

(a) According to 18 U.S.C. § 152, "[w]hoever, either individually or as an agent or officer of any person or corporation, in contemplation of a case under title 11 by or against him or any other person or corporation, or within intent to defeat the provisions of title 11, knowingly and fraudulently transfers or conceals any of his property or the property of such other person or corporation; . . . Shall be fined no more than $5,000.00 or imprisoned not more than five (5) years, or both;"

(b) Also under 18 U.S.C. § 3284, "the concealment of assets of a debtor in a case under title 11 shall be deemed a continuing offense until the debtor shall have been finally discharged or a discharged denied, and the period of limitation shall not begin to run until such final discharge or denial of discharge."

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