Best Practices: Bringing and Defending Fraudulent Conveyance Claims

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I. Investigating and Drafting a Fraudulent Conveyance Claim

A. Parties with standing to assert a claim

1. Debtors-in-possession and trustees

(a) Bankruptcy Code vests the avoidance power in the bankruptcy trustee, which, in a chapter 11 case, also includes the debtor-in-possession

(i) 11 U.S.C. § 548(a)(1) ("The trustee may avoid . . . " transfers made and obligations incurred); 11 U.S.C. § 1107 ("a debtor in possession shall have all the rights . . . and powers, and shall perform all the functions and duties . . . of a trustee . . . .")

(ii) *Official Comm. of Unsecured Creditors of Taylor–Ramsey Corp. v. Ramsey (In re Taylor–Ramsey Corp.)*, 458 B.R. 270, 274 (Bankr. M.D.N.C. 2011) (chapter 11 debtor-in-possession has the right to avoid fraudulent conveyances)

2. Creditors' committees

(a) *Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 330 F.3d 548 (3d Cir. 2003), *cert. dismissed*, 540 U.S. 1002 (2003) (bankruptcy court can authorize creditors' committees to sue derivatively to bring fraudulent conveyance claims)

3. Assignees of debtors (e.g. litigation trust)

(a) *Crescent Resources Litigation Trust v. Burr (In re Crescent Resources, LLC)*, 463 B.R. 423 (Bankr. W.D. Tex. 2011) (litigation trust established under chapter 11 plan had standing to pursue avoidance claims)

4. Potentially creditors

(a) *PW Enters., Inc. v. N.D. Racing Comm'n (In re Racing Servs., Inc.)*, 540 F.3d 892, 898 (8th Cir. 2008) ("derivative standing is

available to a creditor to pursue avoidance actions when it shows that a Chapter 7 trustee (or debtor-in-possession in the case of Chapter 11) is 'unable or unwilling' to do so")

B. Elements of claim

1. Actual fraudulent conveyance claims

(a) Requires actual intent to hinder, delay or defraud present or future creditors

(i) 11 U.S.C. § 548(a)(1)(A) ("if the debtor voluntarily or involuntarily . . . 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 . . . .")

(ii) Uniform Fraudulent Transfer Act § 4 ("if the debtor made the transfer or incurred the obligation . . . with actual intent to hinder, delay, or defraud any creditor of the debtor . . . .")

(b) Heightened pleading standard for actual fraud claims

(i) *Weisfelner v. Blavatnik (In re Lyondell Chem. Co.)*, 543 B.R. 127 (Bankr. S.D.N.Y. 2016) ("when a claim is premised on fraud—and claims for intentional fraudulent transfer are in this category—Fed. R. Civ. P. 9(b), which imposes a heightened pleading requirement, applies.")

(ii) Fed. R. Civ. P. 9(b) ("In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally.")

(c) Use of badges of fraud

(i) *CLC Creditors' Grantor Trust v. Howard Savings Bank (In re Commercial Loan Corp.)*, 396 B.R. 730, 746 (Bankr. N.D. Ill. 2008) ("Because direct evidence of fraudulent intent is rarely available, intent can be inferred from the circumstantial presence of certain factors, or 'badges of fraud.'")

(ii) Bankruptcy courts have used the following badges of fraud:

- lack or inadequacy of consideration;

- the family, friendship or close associate relationship between the parties;
- the retention of possession, benefit or use of the property in question;
- the financial condition of the party sought to be charged both before and after the transaction in question;
- the existence or cumulative effect of the pattern or series of transactions or course of conduct after the incurring of debt, onset of financial difficulties, or pendency or threat of suits by creditors; and
- the general chronology of events and transactions under inquiry. *Soza v. Hill (In re Soza)*, 542 F.3d 1060, 1067 (5th Cir. 2008).

(iii) Many states, following the Uniform Fraudulent Transfer Act, use the following badges of fraud:

- the transfer or obligation was to an insider;
- the debtor retained possession or control of the property transferred after the transfer;
- the transfer or obligation was disclosed or concealed;
- before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
- the transfer was of substantially all the debtor's assets;
- the debtor absconded;
- the debtor removed or concealed assets;
- 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;

- the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;

- the transfer occurred shortly before or shortly after a substantial debt was incurred; and

- the debtor transferred the essential assets of the business to a lien or who transferred the assets to an insider of the debtor.

(d) Proving intent by corporations

(i) *Stone v. Ottawa Plant Food, Inc. (In re Hennings Feed & Crop Care, Inc.)*, 365 B.R. 868, 875 (Bankr. C.D. Ill. 2007) ("The intent of corporate officers and managers controls the intent of a corporation.")

(e) Ponzi-scheme presumption

(i) *Perkins v. Haines*, 661 F.3d 623, 626 (11th Cir. 2011) ("With respect to Ponzi schemes, transfers made in furtherance of the scheme are presumed to have been made with the intent to defraud for purposes of recovering the payments . . . .")

2. Constructive fraudulent conveyance claims

(a) Insolvency

(i) 11 U.S.C. § 101(32)(A) (defining insolvency as "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation . . . .")

(ii) NY Debtor Creditor Law § 271(1) ("A person is insolvent when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured.")

(b) Reasonably equivalent value

(i) *Grochocinski v. Ziegler (In re Ziegler)*, 320 B.R. 362, 375 (Bankr. N.D. Ill. 2005) ("Several factors that have been utilized to determine reasonably equivalent value include: (1) whether the value of what was transferred is equal to the value of what was received; (2) the market value of what was transferred and received; (3) whether the

transaction took place at arm's length; and (4) the good faith of the transferee.")

3. Lookback periods

(a) 11 U.S.C. § 548(a)(1) (two years)

(b) Uniform Voidable Transaction Act § 9 (four years, or one year from discovery) (formerly Uniform Fraudulent Transfer Act)

(c) Some states have adopted other lookback periods

(i) New York Civil Practice Law & Rules § 213(8) (six years, or two years from discovery)

(ii) 14 Maine Revised Statutes Annotated § 3580 (six years, or one year from discovery)

(iii) Mississippi Code Annotated § 15-3-115 (three years, or one year from discovery)

C. Identifying the right defendants

1. Intermediate and subsequent transferees

(a) Bankruptcy Code § 550(a) permits recovery of avoided transaction from initial transferee, the person for whose benefit the transfer was made, or any intermediate or subsequent transferee.

(b) Subsequent transferees may be able to more easily prove the affirmative defense that they provided value for such transfers and that they entered into the transactions in good faith (potentially including without knowledge of the identity and/or insolvency of the initial transferor).

2. Other related claims pursued by debtors related to avoidable transfers

(a) Debtors may consider whether breach of fiduciary duty claims may be brought against the debtor's officers or directors for approving and entering into the transaction that is the subject of the avoidance action.

(i) Breach of fiduciary claims are governed by the applicable state law of the corporation

(ii) Because directors and officers are generally protected by the business judgment defense, and there is no inherent prohibition on continuing to transact business when a

company becomes insolvent, such claims are not always viable even where a fraudulent conveyance claim may be proven.

(b) Claims for aiding and abetting a fraudulent conveyance have not gained traction in the courts

(i) For example, in *Edgewater v. H.I.G. Capital, Inc.*, C.A. No. 3601-VCS (Del. Ch. March 3, 2010), the Delaware court held that the Delaware Fraudulent Transfer Act did not create a cause of action for aiding and abetting a fraudulent conveyance.

(ii) *See also In re Parker*, 399 B.R. 577, 580 (Bankr. E.D.N.Y. 2009), holding a claim for aiding and abetting a fraudulent transfer claims is not a legally cognizable action under New York law via Bankruptcy Code § 544 or under Bankruptcy Code § 548.

D. Choice of forum

1. State vs. federal court

2. Jury trial or judge trial

E. Other commercial considerations

1. Cost of litigation

(a) Fraudulent Transfer Claims are Expensive

(i) A properly presented complaint requires significant time and effort to prepare. Best practice is for plaintiff to have an essentially fully discovered case, and to have consulted with proposed testifying experts on key issues including valuation and solvency, prior to filing the complaint.

(ii) Significant claims tend to have significant defenses. Litigation will almost always be hard fought.

(b) Fraudulent Transfer Claims can draw out for extended periods of time.

(i) Fact-intensive issues related to valuation and/or badges of fraud often require trial – many claims cannot be resolved through motion practice.

(ii) Defendants are often incented to draw claims out

- War of attrition against limited funding of debtor / trustee
- Lengthening proceedings may allow new resolution options to present themselves

(c) Consider the Pros and Cons of Contingency Fee Counsel in Prosecuting Fraudulent Conveyance Claims.

2. Access to/availability of witnesses and relevant documents

(a) Conduct internal investigation before exodus of key witnesses and consider ongoing retention through use of consulting agreements with personnel who will not otherwise be retained as employees.

(b) Effective use of Rule 2004 to conduct pre-litigation external investigation.

(i) The Scope of examinations under Rule 2004 are often described as "unfettered and broad."

(ii) Rule 2004 examinations avoid some of the complications under Rule 7026 discovery.

(iii) But note the "pending proceeding" rule: Rule 2004 examinations may become unavailable if party seeking the examination, or the party from whom the examination is sought, is a party to pending litigation involving issues related to the examination.

3. Effect on other assets and potential claims held by the debtor

(a) Beware of potential inconsistencies with necessary allegations and findings to prevail on fraudulent conveyance claim, and other positions the debtor will need to take in other proceedings or in the case in general.

(i) Examples: Solvency and asset valuation determinations – how will findings on these issues impact other claims or positions of the debtor?

(b) Best Practice: Outline all necessary findings – and arguments to achieve them – and identify any conflict with other claims of the debtor (or defenses to creditor claims). Weigh pros and cons before complaint is filed.

4. Creditor must resolve avoidance action to receive distributions on other claims (section 502(d))

(a) Acts as an embargo on payment of otherwise valid claims of the defendant against the estate while avoidance actions are pending – and, if judgment is rendered in favor of the trustee, until payment.

5. Serves as some measure of leverage depending on the size of the defendant's claim against the estate.

II. Available Defenses Based on Pleadings

A. Personal jurisdiction

1. Courts differ on extraterritorial reach of claims

(a) Recently a judge in the S.D.N.Y. held that a transfer from a foreign company to a foreign parent was susceptible to avoidance under the Bankruptcy Code. *Weisfelner v. Blavatnik (In re Lyondell Chemical Co.)*, 543 B.R. 127 (Bankr. S.D.N.Y. 2016).

(b) Other prior decisions in the same district concluded that the presumption against extraterritoriality applied and that fraudulent conveyance law does not extend to wholly foreign transactions. *See, e.g.*, *SIPC v. Bernard L. Madoff Investment Securities LLC*, 513 B.R. 222 (S.D.N.Y. 2014).

2. Sovereign immunity defenses

(a) Bankruptcy Code § 106 abrogates sovereign immunity defenses to avoidance actions brought under sections 544, 548 and 550.

(b) While many courts have confirmed that such defenses are abrogated, the Court of Appeals for the Seventh Circuit held that such abrogation did not permit the debtor to bring state law avoidance claims against the IRS. *In re Equipment Acquisition Resources*, 742 F.3d 743 (7th Cir. 2014).

B. Timeliness of action, including any amendments to complaint

1. Actions generally must be filed within the later of two years after the filing date, or one year after the appointment of a trustee.

C. Safe harbors provided under section 546(e)

1. Section 546(e) provides in relevant part that debtors cannot seek avoidance of settlement payments made by or to (or for the benefit of) financial institutions or that are made by or to (or for the benefit of) a stockbroker, financial institution or financial participant in connection with a securities contract, except as intentional fraudulent conveyances under §548(a)(1)(A).

2. Several circuit courts have confirmed that this securities "safe harbor" applies to wholly private transactions, including leveraged buyout transactions between private parties, if done pursuant to a securities contract. *See Lowenschuss v. Resorts Int'l, Inc. (In re Resorts Int'l, Inc.)*, 181 F.3d 505, 515-16 (3d Cir. 1999); *Brandt v. B.A. Capital Co. LP (In re Plassein Int'l Corp.)*, 590 F.3d 252, 258 (3d Cir. 2009); *QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.)*, 571 F.3d 545 (6th Cir. 2009); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 986 (8th Cir. 2009); *In re Kaiser Steel Corp.*, 952 F.2d 1230, 1239 (10th Cir. 1991).

3. At least one court avoided the application of the safe harbor provisions to fraudulent conveyance claims relates to a LBO by applying the collapsing transaction doctrine to conclude the transfers in question were part of a larger transaction and not merely a securities contract. *Mervyn's, LLC v. Lubert-Adler Grp. IV, LLC (In re Mervyn's Holdings, LLC)*, 426 B.R. 488, 497 (Bankr. D. Del. 2010).

4. Plaintiffs recently have sought to avoid application of the safe harbor defenses by having the debtor not pursue the claims and then having creditors assign their individual state law claims to a litigation trust under the bankruptcy plan, which trust then brings an action on behalf of the creditors. Courts have split on whether such claims are viable, which decisions remain subject to pending appeals. *Compare Whyte v. Barclays Bank PLC*, 494 B.R. 196 (S.D.N.Y. 2013) *with In re Tribune Co. Fraudulent Conveyance Litigation*, 499 B.R. 310 (S.D.N.Y. 2013) and *Weisfelner v. Fund 1. (In re Lyondell Chemical Co.)*, 503 B.R. 348 (Bankr. S.D.N.Y. 2014).

III. Building Your Case or Defense to the Claim

A. Effective use of experts

1. General Issues:

(a) Fraudulent conveyance cases are typically expert driven and the prevailing expert analysis usually wins the case.

(b) Early evaluation of expert issues and identification of expert candidates is critical.

(c) Team Approach versus One Stop Shopping: evaluate the pros and cons of pinpoint expertise with each separate issue (and the use of multiple testifying experts on assets, liabilities, capitalization, profit projections, etc.), versus using a single expert to prepare the entire analysis.

(d) Pros and cons of using multiple experts – some "consulting" and some "testifying."

B. Insolvency, Unreasonably Small Capital and Value

1. Proving or disproving insolvency

(a) Different Tests:

(i) UFCA: "Fair salable value of assets" compared to "probable liability on existing debts."

(ii) UFTA and Section 548: Balance Sheet Test: "debts" compared to "assets" at "fair valuation"; UFTA also adopts rebuttable presumption of insolvency when debtor is generally not paying its debts as they become due.

(b) Timing Issues:

(i) Relevant inquiry is solvency at time of transfer

(ii) Retrojection and Hindsight:

- Retrojection seeks a presumption that present insolvency existed at time of transfer. Requires evidence that financial condition has not changed since the transfer.

- Hindsight: Insolvency at time of bankruptcy filing equates to insolvency at time of transfer.

(iii) Problem of variable values for both assets (market driven) and liabilities (contingencies).

2. Unreasonably Small Capital / Incurring Debt Beyond Ability to Pay:

(a) Alternative standards for constructive fraud under UFCA and UFTA. Claims under this standard apply to both present and future creditors.

(b) Is necessarily something less than actual insolvency.

(c) Analysis typically turns on reasonableness of projections of anticipated income and liabilities at the time of the transfer.

(d) Ideally, transferee will have contemporaneous projections – coupled with expert testimony that the projections were reasonable at the time.

(e) Courts have rejected hindsight analysis.

3. "Value" issues:

   (a) Significant in both prima facie case and defenses

   (b) Concept of "reasonably equivalent value" and "fair value" is vague and determinations are fact-specific.

   (c) Proving "value" received by debtor

      (i) Relevance of contemporaneous documents (trading value of securities, board documents)

      (ii) Measured from the perspective of unsecured creditors

      (iii) Ponzi schemes -- can you prove debtor received value?

4. Good Faith

   (a) Transferee's defense based on transfer of value to debtor is *also* dependent on "good faith."

   (b) Basic inquiry asks whether transferee knew or should have known that transfer occurred with intent to hinder, delay or defraud creditors.

   (c) Courts may rely on both subjective and objective standards to make determinations on good faith.

C. Proper measure of damages

1. Appropriate remedy (rescission vs. damages)

   (a) Traditional thinking is that remedy is either return of property or value of property

   (b) UFTA provides that court may award "any other relief that the circumstances may require." Some courts have applied this authority to award punitive damages.

   (c) Prejudgment Interest: Is it applicable? Does it run from the date of the transfer or the date of the demand?

2. Cases where potential claim exceeds unpaid creditor claims

   (a) Can a trustee recover more than is required to pay unsecured claims? Some courts say yes.

D. Intercompany and affiliate issues

1. Guaranties and other transfers by affiliates of primary obligor

(a) Upstream Guarantees are frequently used to enhance the collateral position of a lender and to reduce the cost of funds for the borrower. Typically, a subsidiary guarantees the debt of the parent and supplies collateral to support the obligation.

(b) Fraudulent Conveyance Theory: If the subsidiary guarantor becomes insolvent, the recipient of the guaranty and the supporting collateral may be sued for a fraudulent conveyance on the grounds that the subsidiary debtor received no value for the conveyance.

(c) Defenses:

(i) Indirect Benefit Theory: The majority of courts recognize that a subsidiary can obtain an indirect (and sufficient) benefit from providing a guarantee for the benefit of an upstream affiliate.

- The defense can be fact intensive.
- Recent case law from the 11th and 5th Circuits have rejected indirect benefit arguments.

(ii) Savings Clauses: provisions in guarantees that provide that the guarantee is enforceable only to the extent that it would not constitute a fraudulent conveyance. But see 11th Circuit's *Tousa* decision, sustaining bankruptcy court's rejection of savings clause.

2. Use of concentration accounts

(a) Centralized Cash Management Systems ("CMS"): corporate "families" with multiple affiliates and divisions often use a centralized cash pooling mechanism where all cash at all levels is streamed to a centralized entity (often the corporate parent), which manages the payment of all accounts for all the corporate subsidiaries.

(b) Fraudulent Conveyance Theory: In short, CMS structures present the argument that while one party (the subsidiary) received the goods or services from the payee, another party (the CMS parent) paid for those goods and services. If the CMS parent becomes insolvent, the payee may be sued for a fraudulent conveyance.

(c) Defenses:

(i) Debtor received value in form of upstream cash from the subsidiary / Collapse of multiple transactions reveals that debtor received value

(ii) Indirect Benefit Theory

IV. Thinking Ahead - Can You Avoid an Avoidance Claim?

A. Considerations in designing and documenting a transaction

1. Parties can include representations and warranties regarding solvency in transactional documents. Consideration should be given to the solvency of specific corporate entities, not merely the solvency of the corporate group, at the time of the transaction.

2. Fairness opinions – Buyers and sellers may obtain opinions confirming fair value was received by the company at risk of a later bankruptcy filing.

3. Companies in distress as well as transferees benefit from contemporaneous documents prepared with reasonable assumptions and supported by the advice of outside counsel and/or financial advisors that document the benefit of the transaction to the company in distress and the value exchanged.

4. Parties also should give thought to the appropriate form of the transaction (e.g., sale of assets vs. sale of stock), the correct parties to the transaction, and the complete package of assets and liabilities transferred in a given transaction.

B. Other creditors' rights and opportunities

1. Fraudulent conveyance claims typically seek rescission or damages relating to a previously closed transaction

2. Creditors would have to consider other potential recourse in advance of a transaction they want to avoid