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Fraudulent Conveyance Exposure for Intercorporate Guaranties, Integrated Transactions, and Designated-Use Loans

Contours of Section 548 Reasonably Equivalent Value Defense in Complex Lending Transactions

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Discussion

Discussion

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I. Overview

A. Definition

(1) When the debtor transfers a property interest (or incurs a debt obligation) but does not receive value in exchange for that transfer that is reasonably equivalent to what the debtor gave up –***and***–

(2) The debtor is in financial distress, i.e., (a) insolvent or becomes insolvent at the time of the transfer; (b) left with unreasonably small capital to conduct its business; or (c) is too illiquid to pay its obligations as they come due.

B. Actual v. Constructive Fraudulent Transfers

- Intent vs. insolvency: Actual fraud involves the "intent to hinder, delay or defraud" creditors; constructive fraud does not require intent, because it applies in situations of financial distress.
- Where debtor's financial status is or becomes statutorily (as defined) impaired, then it must have received reasonably equivalent value to avoid being constructively fraudulent.

C. Why Guaranties Are at Higher Risk

- Whenever an obligation to a third party is incurred, even if contingent, a question arises as to whether the party incurring the obligation is receiving appropriate value in exchange.
- This is of particular concern in multi-party transactions where an affiliate provides a guaranty, but does not receive loan proceeds or other direct and readily quantifiable benefits.

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II. Typical Loan Scenarios

A. Typical Bank Financing Arrangement

- Operating Company is the Borrower.
- Holding Company provides a guaranty and pledges Borrower's stock to secure the guaranty.
- Borrower's Subsidiaries provide guaranties.
- Sometimes one or more of Borrower's sister companies are a co-borrower or guarantor.

Types of Guarantees

1. Upstream Guarantees
2. Downstream Guarantees
3. Cross-stream Guarantees

B. Co-Borrower Structure

- Sometimes lenders will structure a loan by having multiple borrowers instead of a single borrower supported by guarantors.
- Co-borrower structure does not eliminate fraudulent transfer risk regarding guarantees, if one or more co-borrowers do not receive, or are not entitled to use, loan proceeds.

C. Designated Use Loans

- Where a credit facility is designated for general working capital of corporate group, a borrower's control over the loan proceeds should be easily established.
- Where loan proceeds are contractually designated for a specific purpose, however, borrower has little or no discretion over how the funds are used. Issues also might arise when corporate affiliates are co-borrowers, but use of funds is contractually limited to specified borrowers.
- "Dominion" or "control" tests determine whether the borrower had a property interest in the funds. These tests focus on whether the borrower had "the right to put the money to one's own purposes" or "the ability to use [the money] as he sees fit." *See Nordberg v. Sanchez (In re Chase & Sanborn Corp*.), 813 F.2d 1177 (11th Cir. 1987) (funds wire transferred through debtor's account never became "interest of the debtor in property" in light of debtor's lack of control).

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III. Constructive Fraudulent Transfer Analysis

A. Bankruptcy Code Sections 548 and 544 (Incorporating State Court Analysis/UFTA)

1. 11 U.S.C. § 548 - Constructive fraudulent transfer:

   "The trustee may avoid any **transfer** . . . or any **obligation** . . . 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 . . . received less than a **reasonably equivalent value** in exchange for such transfer or obligation; and . . . was **insolvent** on the date that such transfer was made or such obligation was incurred."

2. 11 U.S.C. § 544 – incorporates state law fraudulent transfer law.

3. Forty-five states have adopted the Uniform Fraudulent Transfer Act ("UFTA") or Uniform Voidable Transactions Act ("UVTA") as their statutory regime. The remainder have adopted the UFCA (MD) or have similar common law (AL, LA, SC & VA).

B. Elements

1. "Transfer"

a. 11 USC § 101(54): "Transfer" means

- Creation of a lien
- Retention of title as a security interest
- Foreclosure of a debtor's equity of redemption
- Each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with (i) property or (ii) an interest in property

b. Includes:

- Loan Repayment Obligations
- Pledges of Collateral
- Guarantees
- Termination of contract rights

c. The Issue: how does transfer impact the debtor's creditors?

- Upstream guaranties – subsidiary guarantees parent obligations. Typically, the lender extends credit to a holding company whose principal assets are the equity in its subsidiaries (perhaps worthless in a bankruptcy scenario), so consequently must rely on guaranties and/or collateral granted by the subsidiaries to secure the repayment obligations.
- Downstream guaranties – parent guarantees its subsidiaries' obligations. Generally less risk because it enhances value to subsidiary. (Note: Do not assume parent automatically receives value based on equity ownership which may turn on solvency of subsidiary.)
- Where lender extends financing to a single obligor for general working capital, lender has strong argument that the loan proceeds are reasonably equivalent in value to the repayment obligation incurred (even though the obligation will include interest and lender's expenses), because " 'reasonably equivalent value' does not demand a precise dollar-for-dollar exchange." *Advanced Telecomm. v. Allen*, 490 F.3d 1325, 1326 (11th Cir. 2007)
- Because a guarantor does not generally receive the loan proceeds, the question arises as to what it receives in exchange for incurring the repayment obligation.

c. The Issue: how does transfer impact the debtor's creditors? (cont'd)

- Upstream guaranties can be the most vulnerable to fraudulent conveyance attack because the conveyance -- the subsidiary's incurrence of a guaranty obligation, often secured by the subsidiary's pledge of collateral -- is made by an entity that does not directly receive loan proceeds.
- Lenders might not be able to demonstrate a direct benefit to the subsidiary as the primary "value" arises from a borrower's receipt of loan proceeds.

d. Timing Issues

1) Transaction is evaluated when it occurs.

- Under UFTA, an "obligation is incurred…when the writing executed by the obligor is delivered to or for the benefit of the obligee."
- Under § 548(a)(1) – debt obligation arises when it becomes legally binding under non-bankruptcy law. *Tidwell v Amsouth Bank (In re Cavalier Honmes of Georgia, Inc.)*, 102 B.R. 878,887 (Bankr. M.D. Ga. 1989) (contingent obligation arises when it is legally binding, not when paid).
- § 548(d) "a transfer is made when such transfer is so perfected that a bona fide purchaser from the debtor against whom applicable law permits such transfer to be perfected cannot acquire an interest in the property transferred that is superior to the interest in such property of the transferee… ."
- Financial distress issues are determined at the time of the financing. If entity is solvent and the other financial distress tests are also met, then the reasonably equivalent value analysis becomes moot.

Revolving Loans: when is the transfer made?

- When the executed guaranty is delivered, and the obligation is incurred.
- Generally, the financial distress analyses are made at the time of the initial advance of funds to borrower under the loan documents.
- With respect to guarantors, this ensures the analysis is when the guaranty is signed, so that a separate fraudulent conveyance analysis will not be made each time an advance is made to the principal debtor -- which could be over a period of months or years.
- If there is a secured guaranty, the analysis is also made upon the filing of an initial financing statement.

d. Timing Issues (cont'd)

- Seminal case of *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979 (2d Cir. 1981) reversed the district court's dismissal of fraudulent transfer claims for failure to establish insolvency on the date transaction closed, holding that guarantor's solvency is tested at the time of each draw.
- Section 6(5) of the UFTA was thereafter amended to provide that "an obligation is incurred: (i) if oral, when it becomes effective between the parties; or (ii) if evidenced by a writing, when the writing executed by the obligor is delivered to or for the benefit of the obligee." Comment 3 to Section 6 (revision done to resolve uncertainty arising from *Rubin*, holding that a guaranty obligation may be deemed to be incurred when advances covered by the guaranty are made rather than when the guaranty first became effective between the parties).
- *See In re Tousa*, 44 B.R. 614 (Bankr. S.D. Fla. 2009), relying on § 548(d) in stating that a transfer is made when it is perfected as against a bona fide purchaser from the debtor under applicable law.

2. Financial Distress Tests

- To prove constructive fraud, a plaintiff must satisfy one of three alternative financial distress tests by showing debtor was: (a) Insolvent; (b) had Unreasonably Small Capital; or (c) Lacked Sufficient Liquidity to Pay its Debts as they Mature.
- Only "insolvent" is defined under the Bankruptcy Code.
- Timing: Financial Distress Test is applied to debtor both immediately before and as a consequence of disputed transfer or incurrence of obligation.
- Tests apply only to debtor/transferor, not to entire corporate family. *See Rubin*, 661 F.2d at 995.
- Courts have substantial discretion when applying financial distress tests.

a. Insolvency

1) Insolvency – Relevant Statutory Language

- § 548(a)(1)(B)(ii)(I) – Requires that debtor "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."
- § 101(32) – "The term 'insolvent' means – (A) with reference to an entity other than a partnership or municipality, 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 –" property transferred through actual fraud and exempt property.
- <u>No presumption of insolvency</u> as under § 547.

2) Insolvency – How Measured?

- Balance Sheet Test, but not based on book values; assets and liabilities are marked to market, including Contingent Assets and Liabilities. *See Rubin*, 661 F.2d at 995-96; *Paloian v. LaSalle Nat'l Bank Assoc.*, 619 F.2d 688, 693-94 (7th Cir. 2010) (Use fair market values and include contingent assets and liabilities).
- Courts should take a flexible approach for insolvency analysis that requires consideration of the totality of the circumstances. *See In re Roblin Indus., Inc.*, 78 F.3d 30, 38 (2d Cir. 1996).
- If debtor's business not viable as going concern, then liquidation value might be appropriate valuation methodology. *See Toy King*, 256 B.R. at 163.

3) Insolvency – How are Contingent Liabilities and Assets Valued?

- Courts assess percentage likelihood of contingency occurring and apply that percentage to asset or liability's face value. See *In re Chase and Sanborn Corp.*, 904 F.2d 588, 594 (11th Cir. 1990); *Baldi v. Samuel Son & Co. Ltd.*, 548 F.3d 579, 582 (7th Cir. 2008) (Discount is based on likelihood liability will become fixed).
- Note: *In re Xonics Photochemical*, 841 F.2d 198, 200 (7th Cir. 1988) suggests applying discount percentage to value of guarantor's net assets rather than to face amount of guaranteed debt on theory only net assets would be available to satisfy guaranty obligation.
- Same discounting principle requires assets and liabilities to be present valued for purposes of determining whether insolvent. *See id.*; *In re Ollag Construction Equip. Corp.*, 578 F.2d 904, 909 (2nd Cir. 1978).

4) Insolvency – Relevance of Market Capitalization and Bond Trading Prices

- Positive equity trading value not determinative of solvency. *See Paloian*, 619 F.3d at 694.
- To determine solvency Court may consider contemporary evidence of market value of debtor's equity and parties' willingness to lend to or invest in debtor, even if based on reasonable projections that turned out to be wrong. *See In re Iridium Operating LLC*, 272 B.R. 283, 346-47 (Bankr. S.D.N.Y. 2007).
- Debtor's "ability to issue unsecured bond debt and stock" is "strongest indication of solvency based on the market", but of limited utility if "financial statements on which the market relied were false and misleading" or otherwise insufficient. *In re Tronox, Inc.*, 503 B.R. 239, 298 (Bankr. S.D.N.Y. 2013).
- Credit Agency downgrades also might be useful evidence.

b. Unreasonably Small Capital

1) Definition

- Debtor is adequately capitalized if able to borrow amounts needed to remain liquid and no loss of such availability is "reasonably foreseeable". (Potential right of banks to call default and preclude borrowing is too speculative to form basis for unreasonably small capital finding.) *In re Semi Crude L.P.*, 648 Fed. Appx. 205, 211-12 (3rd Cir. 2016).
- Undercapitalization means debtor has excessive leverage; so key is adequacy of cash sources. *See Baldi v. Samuel Son & Co., Ltd.*, 548 F.3d at 583-84.
- Business has unreasonably small capital "whenever it cannot reasonably anticipate resources needed to effect the timely payment of its trade obligations" without necessity of stretching payables (because trade creditors do not assume that risk). *See In re CNB Int'l, Inc.*, 393 B.R. 306, 327. (Bankr. W.D.N.Y 2008). In contrast, long-term debt holders might be presumed to agree to extended terms due to unforeseen circumstances. *See id.*

2) Unreasonably Small Capital – Need For Reasonable Projections

- "[U]nreasonably small capitalization" is "a general inability to generate enough cash flow to sustain operations" where the "critical question is whether the parties' projections were reasonable" "as tested by an objective standard anchored in the company's actual performance" *In re Tronox Inc.*, 503 B.R. at 320-21 (citations omitted).
- While there is must be a "margin for error", adequate capitalization does not require "resources sufficient to withstand all setbacks." *In re Iridium Operating LLC*, 373, B.R. 283, 345 (Bankr. S.D.N.Y. 2007).

3) Unreasonably Small Capital – Key Factors

- Factors relevant to unreasonably small capital determination include debt to equity ratio, historical capital cushion, need for working capital, and reasonableness of financial projections. *See In re Norstan Apparel Shops, Inc.*, 367 B.R. 68, 79 (Bankr. E.D.N.Y. 2007).

c. Insufficient Liquidity to Pay Debts as they Mature

1) Legal Standard

- § 548(A)(1)(B)(III) requires debtor "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."
- Requires proof of debtor's subjective intent.
- Such intent is different than the "actual intent to hinder, delay, or defraud" any creditor that is necessary to prove actual fraud under § 548(a)(1)(A).

2) Insufficient Illiquidity – Focus on Short Term Impact on Trade Creditors

- Subjective element of actual intent or belief, or objective element of reasonably should have believed, would incur debts beyond ability to pay as they become due. *See In re Tronox Inc.*, 503 B.R. at 323-24.
- Focus is more on "short-term" than unreasonably small capital test and key is treatment of trade creditors. *See id.*

3. Reasonably Equivalent Value ("REV")

- Fraudulent conveyance concern is that a financially stressed debtor often will engage in transferring property or incurring an obligation in exchange for significantly less valuable consideration, thereby constructively defrauding innocent creditors due to depletion of the debtor's estate. *See Rubin*, 661 F.2d at 988.
- REV is not exact equivalency: "the concept of reasonably equivalent value does not demand a precise dollar-for-dollar exchange." *Advanced Telecomm. v. Allen*, 490 F.3d 1325, 1326 (11th Cir. 2007).
- Key questions: (a) how is "value" measured to determine if it is reasonably equivalent; (b) to what extent may indirect benefits a debtor receives in connection with, but not in exchange for, the challenged transfer be factored into that calculation?; and (c) are indirect benefits "property" that can provide REV?

a. Tests to Evaluate whether REV was Received

In re Toy King Distrib., Inc., 256 B.R. 1, 133-34 (Bankr. M.D. Fla. 2000) identifies 3 possible approaches:

1. **Objective test** is a mathematical formula with a per se lack of equivalent value when transfer is for less than 70% of fair market value of debtor's transferred property. *See Durrett v. Washington Nat'l Ins. Co.*, 621 F.2d 201, 203-03 (5th Cir. 1980). While a useful starting point, the Objective Test is rejected by many courts. *See, e.g., In re Bundles*, 856 F.2d 815, 823-24 (7th Cir. 1988).

2. **Subjective test** focuses on fairness. Consideration is presumed fair so long as it is not so far short of transferred property's real value as to shock the moral sense. (i.e., a "smell test."

3. **"Totality of the Circumstances" test** combines objective and subjective elements. Court looks "to the 'totality of the circumstances' surrounding transaction to determine whether 'fair consideration' or 'reasonably equivalent value' is given in exchange for a transfer of property." Court considers transfer from creditor's perspective. *See, e.g., In re Grissom*, 955 F.2d 1440, 1445-49 (11th Cir. 1992) ("requires thorough inquiry of all relevant facts and circumstances").

b. May Indirect Benefits Help Provide REV?

- *General Rule*: Transfers in exchange for benefits received solely by third parties do not furnish REV to transferor.
- *Qualification*: REV may be in the form of direct benefit to a third party that indirectly benefits transferor.

Rubin v. Manufacturers Hanover Trust Co., 661 F.2d 979, 991 (2d Cir. 1981) states (regarding "fair consideration" under the Bankruptcy Act):

- "[T]hree-sided transactions such as [the upstream guaranties] at issue here present special difficulties under the [statute's] definition of fair consideration" because despite the statutory language, the benefit to the third party is not what is measured against the value of the consideration the debtor provides.
- Nonetheless, while "transfers *solely* for the benefit of third parties do not furnish fair consideration," a "transaction's benefit to the debtor 'need not be direct; it may come indirectly through benefit to a third person.' "
- Analyze from creditors' perspective: "the primary focus of section 548 is on the net effect of the transaction on the debtor's estate and funds available to unsecured creditors." *In re Northern Merch. Inc.*, 371 F.3d 1056, 1059 (9th Cir. 2004).

c. Indirect Benefits Based on Identity of Interests

In re Royal Crown Bottlers of North Alabama, Inc., 23 B.R. 28 (Bankr. N.D. Ala. 1982):

- Trustee brought fraudulent conveyance claim to recover payment by debtor, a wholly owned subsidiary, to satisfy debtor's parent's obligation. Court acknowledged "general rule" that "an insolvent debtor receives 'less than a reasonably equivalent value' where it transfers its property in exchange for a consideration which passes to a third party," but reasoned:
  - "A clear distinction from this rule exists, however, if the debtor and the third party are so related or situated that they share an 'identity of interests,' because what benefits one will, in such case, benefit the other to some degree. The ultimate question then becomes one of determining the value of this vicarious benefit and testing it by the measure of 'reasonably equivalent' for the property transferred by the insolvent debtor." *Id.* at 30 (*citing Rubin*, 661 F.2d at 992).
- Similar analysis applies when subsidiary incurs an obligation, such as an upstream guaranty of its parent's debt:
  - "When the consideration for a transfer passes to the parent corporation of a debtor-subsidiary making the transfer, as in the case here, the benefit to the debtor may be presumed to be nominal, in the absence of proof of a specific benefit to it." *Id.* at 30.
  - Court then speculated such benefits might consist of the debtor's receipt of: (i) "substantial" financial aid (even if such aid turned out to be futile); and (ii) operational benefits to the debtor's bottling business due to the debtor's payment aiding its parent.

c. Indirect Benefits Based on Identity of Interests (cont'd)

Telefest, Inc. v. VU-TV, Inc., 591 F. Supp. 1368 (D.N.J. 1984):

- VU-TV, a wholly owned subsidiary of CATV Products, Inc., agreed to guarantee, and executed security agreement to collateralize, a loan to its parent. Creditor argued debtor's guaranty and security agreement were avoidable under New Jersey's fraudulent transfer statute (substantially the same as section 548).
- In finding VU-TV received fair consideration, Court cited *Royal Crown*'s "identity of interests" principle and found "a benefit would flow to VU-TV through the loans . . . ultimately guaranteed by VU-TV." *Id.* at 1379. Court endorsed principle that debtor could receive value from "guaranty of a loan to a third party . . . whose continued health and existence is vitally important to the guarantor".
- In itemizing indirect benefits to debtor, Court noted: "[m]onies loaned to VU-TV's parent to purchase a cable television system or for other moves directed toward expansion would most probably provide an additional and obviously secure market for VU-TV," that "may not have been a direct benefit, but it was specific enough benefit" warranting finding that "fair consideration inhered in the conveyance." *Id.*
- NOTE: Cases relying on identity of economic interests are just using an alternative perspective for fulfilling "statutory purpose of conserving the debtor's estate for the benefit of creditors." *Rubin*, 661 F.2d at 992.

d. Are Indirect Benefits "Property"?

- Section 548(d)(2)(A) provides that for purposes of section 548 "value" is defined as: "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." (Emphasis added).
- As the payment or securing of debt of a third party (even one's own corporate parent) is not to satisfy a debt "of the debtor," an indirect benefit must fall under the other category – "property" – to qualify as "value."
- The term "property" is not defined in the Bankruptcy Code and is subject to a narrow definition covering only assets that can appear on a debtor's balance sheet.
- Consideration of indirect benefits as value would be precluded by using such a narrow view of "property." *See, e.g., In re TOUSA, Inc.*, 422 B.R. 783, 868 n. 55 (Bankr. S.D. Fla. 2009) (Bankruptcy Court refuses to consider alleged indirect benefits as "value" because "Section 548 does not refer to 'benefits,' whether direct or indirect. It requires reasonably equivalent 'value' and includes a precise definition of 'value' that encompasses only 'property' and 'satisfaction or securing of a present or antecedent debt of the debtor.' ") (reversed by District Court – including on this issue; largely reinstated by 11th Circuit, but silent on this point).

d. Are Indirect Benefits "Property"? (cont'd)

- Most courts, however, are prepared to find REV based on indirect benefits that would not qualify as "property" under strict definitions of the term:
  - Eighth Circuit has stated that indirect benefits are not limited to "legal or equitable rights or ownership interest," consideration should be given to "all benefits and burdens to the debtor, direct or indirect, including indirect economic benefits" and, therefore, "value" should not be defined "only in terms of tangible property or marketable financial value." *United States v Crystal Evangelical Free Chur*ch, 82 F.3d 1407, 1415 (8th Cir. 1996), vacated on other grounds, 521 U.S. 1114 (1997).
  - Third Circuit found that "mere 'opportunity' to receive an economic benefit in the future constitutes 'value' under the Code" if expectation of value was "legitimate and reasonable" and "potential, intangible benefits" could be deemed to have "conferred value on [the debtor] despite their failure to materialize," and rejected argument that "the only value that can be considered is property actually received" or "direct, tangible economic benefit." *Mellon Bank, N.A. v. Official Comm. of Unsecured Creditors of R.M.L.*, 92 F.3d 139, 148, 151-52 (3d Cir. 1996) (But Court found no REV from payments for loan commitment because "chances of the loan closing were negligible").
  - 11th Circuit states section 548(a) "does not authorize voiding a transfer which 'confers an economic benefit upon the debtor,' either directly or indirectly." *In re Rodriguez*, 895 F.2d 725, 727 (11th Cir. 1990).

e. Indirect Benefits Constitute REV Only if they have a Sufficient Measureable, Positive Impact

- In *Tousa*, relying on *Telefest* and similar cases, lenders argued the corporate enterprise's intertwined relationships meant the subsidiaries received indirect benefits from their loan guaranties, such as continued access to centralized services and cash flow plus avoidance of a likely default under their collective $1 billion bond financing. 11th Circuit rejected lenders' arguments because bankruptcy court had answered no to the following question: "based on the circumstances that existed at the time the investment was contemplated, [was] there . . . any chance that the investment would generate a positive return"? *In re TOUSA, Inc.*, 680 F.3d 1298, 1313 (11th Cir. 2012).

e. Indirect Benefits Constitute…Positive Impact (cont'd)

- Examples of intangible indirect benefits that may constitute REV (but are not "property" under a narrow definition of that term) include improvements to:
  - "a corporation's goodwill or
  - increased ability to borrow working capital;
  - the general relationship between affiliates or 'synergy' within a corporate group as a whole; and
  - a corporation's ability to retain an important source of supply or an important customer. . . ." *In re Image Worldwide, LTD.*, 139 F.3d 574, 578-79 (7th Cir. 1998) (citations omitted).
- Most notable line of cases finding no "value" is when the transferee claims amorphous, non-economic benefits such as "spiritual fulfillment," "love and affection," or "preservation of [a] family relationship." Those types of benefits have been found inadequate because they are non-economic in nature. Hence, they "are not likely to be of much benefit to creditors." *Allard v. Flamingo Hilton*, 69 F.3d 769, 776 (6th Cir. 1995).

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IV. Transactions at Particular Risk

A. Leveraged Buyouts

- Acquisition target borrows, secures, or makes payments in satisfaction of a loan whose proceeds are designated for payouts to the selling shareholders.
- Issue of whether target obtained reasonably equivalent value for the debt it incurred.
- Courts will review the substance of a multi-step transaction to determine whether to collapse a series of steps, exchanges, or transaction into one integrated transaction that deprived the target of REV.

Collapsing The Transactions

- Under certain circumstances courts may collapse a series of separate steps or transactions into a “single integrated transaction” and consider the result. Doctrine permits courts to ignore a borrower's temporary interest in the loan proceeds and consider the net result to determine “reasonably equivalent value” to target/borrower. *Official Comm. Of Unsecured Creditors v. Clark*, 344 B.R. 340, 348 (W.D. Pa. 2006)
- Collapsing transactions enables court to deviate from rule that value must be measured as of the time of the transfer, and determine that a debtor received less than reasonably equivalent value from a loan -- notwithstanding its receipt of the loan proceeds -- because of the use to which those loan proceeds subsequently were put.

Collapsing The Transactions

- Factors relevant to whether court should collapse related transactions are:

(1) whether all of the parties involved had knowledge of the multiple transactions;

(2) whether each transaction would have occurred on its own; and

(3) whether each transaction was dependent or conditioned on other transactions.

In re Adelphia Communications, 512 B.R. 447, 491 Bankr. S.D.N.Y. 2014)

Collapsing The Transactions

Bay Plastics v. BT Commercial Corp. (In re Bay Plastics), 187 B.R. 315 (Bankr. C.D. Cal. 1995)

- Case arose from a failed LBO pursuant to which BT lent $3.95 million to Bay Plastics, which promised to repay the loan and gave a first priority security interest in all of its assets to secure the repayment.
- BUT there was a second transaction in which Bay Plastics directed that $3.5 million be transferred to its incoming parent, BPI, and BPI in turn directed that the funds be paid out for stock purchase. In substance $3.5 million of the funds that Bay Plastics borrowed from BT went to pay for the stock of the selling shareholders, rather than Bay Plastics.
- Court collapsed the two stages into a single integrated transaction, resulting in a finding Bay Plastics received only $450,000 in value from the $3.95 million loan proceeds (i.e., "the $3.95 million loan less the $3.5 million paid to the selling shareholders"), which was "not reasonably equivalent to the $3.95 million obligation that it undertook."

Collapsing The Transactions

- *See also, HBE Leasing Corp. v. Frank*, 48 F.3d 623, 635 (2d Cir. 1995)
- *United States v. Gleneagles Investment Co*., 565 F.Supp. 556 (M.D. Pa 1988) *aff'd sub nom. U.S. v. Tabor Court Realty Corp*., 803 F. 2d 1288 (3d Cir. 1966)

Designated Purpose Loans

- Where proceeds of a loan are specifically directed to a single designated purpose or entity, question arises as to what consideration went to any additional obligors (guarantors or co-borrowers).
- Difficulties in analyzing complex multi-party transactions reflected in the three opinions involved in connection with a designated purpose loan in *In re Tousa, Inc.*, 422 B.R. 783 (Bankr. S.D. Fla. 2009), *quashed in part*, 444 B.R. 613 (S. D. Fla. 2011), *aff'd in part, rev'd in part*, 680 F.3d 1298 (11th Cir. 2012) and order aff'd, 2017 WL 8785510 (S.D. Fla. 2017).

B. The Control Test

- *In re Tousa*, 422 B.R. 783 (Bankr. S.D. Fla. 2009). Simplified, Debtor parent company borrowed money to settle a lawsuit against it, secured with the assets of its subsidiaries, who were co-borrowers on the loan but not defendants in the lawsuit. When the subsidiaries filed for bankruptcy, their Committee sought to void the loans and liens they had granted to the lender as fraudulent transfers, and to recover the settlement paid that such loans funded for the parent to settle the lawsuit.
- Held: loan payment by debtor parent to settle lawsuit was transfer of property interest by subsidiary debtors that secured loan; subsidiaries' liens to lender were fraudulent transfers and voided; parent's settlement payment was fraudulent transfer and avoided.
- On appeal, the District Court reversed, holding (among other things) that the subsidiary debtors did not have a sufficient control over the loan proceeds, which were specifically designated for settlement of the parent's lawsuit, to qualify as a property interest for fraudulent transfer purposes. *In re Tousa*, 444 B.R. 213 (S.D. Fla. 2011). The Court of Appeals reversed, holding that the settlement payment recipient was an "entity for whose benefit the transfer was made" and that the bankruptcy court's finding was proper. *Tousa*, 680 F.3d 1298 (11th Cir. 2012)

B. The Control Test (cont'd)

- *Dillworth v. Ginn*, No. 10-2976, 2010 WL 8756756 (Bankr. S.D. Fla. Dec. 10, 2010)
  - Debtors guaranteed and secured $148 million loan, but did not receive proceeds. Trustee sought to avoid transfer of debtors' alleged "interest" in loan proceeds.
  - Creditors moved to dismiss, arguing that trustee cannot avoid direct transfers of non-debtor property to non-debtor borrowers. Loan proceeds were not debtors' property because the debtors were merely "subsidiary guarantors" with no control over the loan proceeds.
  - Court rejected argument that debtors must be able to control property to have a property interest, holding a debtor may have an interest in property for avoidance purposes "even if the debtor has no power to prevent some other party from transferring the property." (But still granted motion to dismiss.)
- Even if loan proceeds pass through an entity as borrower, courts will scrutinize whether borrower gained sufficient control over proceeds for them to be borrower's "property," under the dominion or control tests, sufficient to constitute value or consideration.

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V. Fraudulent Transfer Mechanics

A. Who Pursues a Constructively Fraudulent Transfer?

1. Typically pursued in a bankruptcy case by the Trustee/Debtor in Possession, but Creditors' Committee may be deputized under certain circumstances.

2. Outside of bankruptcy cases (or if the actions are abandoned by the Trustee/Debtor) constructively fraudulent conveyances may be brought by creditors. Under 544, Trustee must plead and prove that a creditor exists that could avoid the transaction

3. Most states have a 4-year lookback period (*but be careful—a few states have a longer lookback period). NOTE: NY's law recently changed so the longer look back period only applies to transfers before a specified date.*

4. In bankruptcy, fraudulent transfer must be pursued by adversary proceeding.

B. Burden of Proof

- Plaintiff has the burden of going forward and the ultimate burden of proof in establishing each of the elements of a fraudulent transfer by a preponderance of the evidence.
- Once Plaintiff establishes there was no direct value in exchange for the transfer, however, Defendants must come forward to establish indirect value.
- "Although the Plaintiff has both the burden of going forward in attempting to establish that the Conveying Subsidiaries did not receive 'value' directly, and has the ultimate burden of proof, it is equally the case that upon a *prima facie* showing by the Plaintiff of no direct value, the Defendants have the burden of going forward to establish that the Conveying Subsidiaries received indirect 'value,' *In re Aqua Clear Technologies, Inc.*, 361 B.R. 567, 582 (Bankr. S.D. Fla. 2007), and that such indirect value was tangible, concrete, and **quantified with reasonable precision**. *In re Richards & Conover Steel Co.*, 267 B.R. 602, 614 (8th Cir. BAP 2001).“

Tousa, 408 B.R. at 438.

B. Burden of Proof (cont'd)

- Whether or not reasonably equivalent value was given will be viewed from the perspective of the debtor's creditors.
- Practically, where there is no "direct" benefit to the guarantor, the defendant should assume it has the burden of proving debtor received reasonably equivalent value.

C. Who May Be Liable

- 11 U.S.C. § 550(a): "Except as otherwise provided in this section, to the extent that a transfer is avoided under Section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property from (1) the initial transferee of such transfer or *the entity for whose benefit such transfer was made.*"
- 11 U.S.C. § 550(b): The Trustee may not recover from a transferee that takes for value, in good faith, and without knowledge of the voidability of the transfer avoided or its immediate or mediate good faith transferee.

NOTE: Fraudulent Transfers that are incurred obligations may be avoided (i.e., cancelled), but do not result in an affirmative recovery.

D. Potential Defenses

- Debtor remained solvent and viable following challenged transfer.
- Debtor received reasonable equivalent value in the form of indirect benefits.
- Debtor received the benefit of the property for which it made payment.
- Debtor had no interest in the actual transferred property.
- Defendant provided value in good faith (11 U.S.C. § 548(c)).
- Defendant is not an initial, immediate or mediate transferee under § 550(a) (Liability of transferee of avoided transfer).
- Defendant transferee took for value, or in satisfaction of an antecedent debt, in good faith, without knowledge of the voidability of the transfer avoided, or an immediate or mediate good faith transferee under § 550(b).

Good Faith for Value Defense and 548(d)(2)

General rule: transferee has lien on or retains the interest transferred to the extent of value given to the debtor (548(c)).

- Two requirements:

(1) Good faith (honesty in fact and observance of reasonable commercial standards, specifically was there inquiry notice and if so, was there an investigation?) and

(2) Provide value.

548(d)(2)(B)-(E)- protects transfers to financial intermediaries, recipients of stock or margin payments, repo and swap participants, master netting particpants from constructive fraudulent transfer claims

LBO Defense — 546(e) Safe Harbor

- 11 U.S.C. 546(e) shields certain payments involving financial institutions:
  - "Notwithstanding sections 544 [incorporating state fraudulent transfer claims], … 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a …settlement payment …made by or to (or for the benefit of) a …financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a …financial institution, … in connection with a securities contract… made before the commencement of the case…."
  - Courts have applied 546(e) to LBO transactions where financial institutions are involved to protect transferees. *See e.g. Guiliano v. Schnabel, et al. (In re DSI Renal Holdings, LLC)*, 617 B.R. 496 (Bankr. Del. 2020) (collapsing prepetition restructuring transactions involving transfers of stock and finding that safe harbor barred recovery); *In re Nine West LBO Securities Litigation*, 482 F.Supp. 3d 187 (S.D.N.Y. 2020); *In re Tribune Company Fraudulent Conveyance Litigation*, 946 F.3d 66 (2d Cir. 2019) (fraudulent transfer claims preempted by 546(e)).

- By its terms, 546(e) applies to transfers, and not obligations. *But see Lehman Bros. Holdings Inv. V. JPMorgan Chase Bank, N.A. (In re Lehman Bothers Holdings Inc*.), 469 B.R. 415, 443-46 (Bankr. S.D.N.Y. 2012) (confirming obligations not exempt under 546(e) but effectively extending it to shield guarantee obligations from avoidance because liens and collateral transfers related to guaranties were independently immune under 546(e))

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E. Proving Value of Indirect Benefits

1. Basic Approach to Proving Value of Indirect Benefits:

- Fact Intensive; Substantial Judicial Discretion: "It has long been established that 'whether fair consideration has been given for a transfer is "largely a question of fact, as to which considerable latitude must be allowed to the trier of the facts.' " *In re Chase & Sanborn Corp.*, 904 F.2d 588, 593 (11th Cir. 1990) (quoting *Mayo v. Pioneer Bank & Trust Co.*, 270 F.2d 823, 829–30 (5th Cir. 1959) (Wisdom, J.), *cert. denied* 362 U.S. 962 (1960)).
- Expert analysis is important.
- Identify benefits and have expert(s) quantify (at least as to a general range).

E. Proving Value of Indirect Benefits (cont'd)

2. Potential Indirect Benefits Include:

- Preservation or Enhancement of Goodwill
- Increased ability to borrow and/or other positive loan agreement amendments (but only if such improvements would be of use)
- Synergy
- Retention of important supply source or customer
- Preservation or acquisition of Operational Benefits such as centralized cash management, purchasing, and administrative services (but only if such benefits would be lost absent the challenged transfer)
- Favorable contract modifications
- Tax benefits
- Elimination of litigation costs and risks (e.g., by funding a settlement)
- Avoidance of Bankruptcy (but see next slide)

E. Proving Value of Indirect Benefits (cont'd)

3. Avoidance of Bankruptcy by Itself is Unlikely to Constitute REV:

- "A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it." *Bloor v. Dansker (In re Investors Funding Corp. of New York Sec. Litig.*), 523 F. Supp. 533, 541 (S.D.N.Y. 1980).
- "The opportunity to avoid bankruptcy does not free a company to pay any price or bear any burden. After all, 'there is no reason to treat bankruptcy as a bogeyman, as a fate worse than death.' " *Olympia Equip. Leasing Co. v. W. Union Tel. Co.*, 786 F.2d 794, 802 (7th Cir. 1986) (Easterbrook, J., concurring).
- Avoidance of bankruptcy provides no value if later bankruptcy filing "inevitable" or avoiding bankruptcy is "the more harmful option." *In re Tousa*, 422 B.R. at 846-47 (Bankruptcy Court's decision).

E. Proving Value of Indirect Benefits (cont'd)

4. Factors Potentially of Use to Demonstrate Indirect Benefits Constitute REV:

- Fair Market Value
- Whether Disputed Transfer was Arm's Length/Relationship of Parties
- Unforeseen Changes in Economic Circumstances After Disputed Transfer
- Industry Standards
- Transaction was to help avoid/defer bankruptcy:
  - Emphasize deferral created realistic opportunity to address financial problems
  - Value of goodwill that could be lost
  - Value of shareholder equity that could be lost

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VI. Practical Steps for Lenders to Minimize Risks

Best Practices

A. Conduct Due Diligence

1. Analyze Solvency

- Closely analyze each party in the transaction. Identify what value is being provided and what value is being received.
- Make sure real value is being given and received.
- If the solvency of the transferor is questionable, get an independent valuation of the company.
- Step back and consider how would an objective third-party evaluate this situation.
- Do not be afraid to terminate the deal and exit the relationship (or call a default) if the situation warrants it.

2. Document Facts

- Document due diligence that was done.
- Include representations as to financial condition of guarantor and financial covenants to measure its condition in loan agreement.
- Certificate of CFO of guarantor as to financial condition of guarantor delivered at cause
  - Include evidence that accounts payable are current and future ability to pay.
- Include evidence of “synergy,” other “indirect benefits,” and/or “identity of interests” between borrower and guarantor.

3. Follow internal policies and report suspicious activities.

B. Solvency Certificate

- Require delivery of a solvency certificate at close, which certifies as to:
  - Solvency at the time of the transaction
  - Not rendered insolvent as a result of the transaction
  - Not left with unreasonably small capital with which to conduct present or future business
  - Not incurring, or intending to incur, debts beyond ability to pay as such debts come due.

C. Consider Limiting the Guaranty

- Limit guarantor liability for portion of debt being waived.
- Limit guaranty to net worth (or 80%-90% of net worth) of guarantor, so that guaranty can never render a guarantor insolvent.
  - These limits are rarely used.
  - Could potentially exclude assets from guaranty.
  - Monitoring and determination issues.
- Savings Clauses
  - These limit guarantees to an amount not constituting a fraudulent conveyance.
  - Widely used, but may not survive court scrutiny. *See Tousa*, 422 B.R. at 864 (savings clauses invalid under § 541(c) as *ipso facto* clause, and too indefinite to be enforceable under contract law).
- Contribution and reimbursement agreements for co-borrowers/guarantors.

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