Strafford

Presenting a live 90-minute webinar with interactive Q&A

Partnership and LLC Bankruptcies: Unique Legal Issues and Recent Case Law Developments

WEDNESDAY, APRIL 1, 2020

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Michael J. Riela, Partner, **Tannenbaum Helpern Syracuse & Hirschtritt**, New York

Richard W. Trotter, Attorney, **Tannenbaum Helpern Syracuse & Hirschtritt**, New York

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 1**.

Tips for Optimal Quality

FOR LIVE EVENT ONLY

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-877-447-0294** and enter your **Conference ID and PIN** when prompted. Otherwise, please **send us a chat** or e-mail **sound@straffordpub.com** immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality

To maximize your screen, press the 'Full Screen' symbol located on the bottom right of the slides. To exit full screen, press the Esc button.

Continuing Education Credits

FOR LIVE EVENT ONLY

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For additional information about continuing education, call us at 1-800-926-7926 ext. 2.

Program Materials

FOR LIVE EVENT ONLY

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the link to the PDF of the slides for today's program, which is located to the right of the slides, just above the Q&A box.
- The PDF will open a separate tab/window. Print the slides by clicking on the printer icon.

Tannenbaum Helpern
Syracuse & Hirschtritt LLP

Partnership and LLC Bankruptcies: Unique Legal Issues

April 1, 2020

Presented by:

Michael J. Riela, *Tannenbaum Helpern Syracuse & Hirschtritt LLP*

Richard W. Trotter, *Tannenbaum Helpern Syracuse & Hirschtritt LLP*

What Makes a Partnership or LLC?

- Partnership is governed by the partnership agreement.
- An LLC is governed by operating agreement/LLC agreement.
- Who Acts for the Partnership? The general partner is an agent for the partnership.
- Who Acts for the LLC? An LLC may be either member-managed or manager-managed.
  - If manager-managed, then the Managing Member is an agent for the LLC.
- Partners and Members Have Various Rights:
  - Rights in the property owned by the partnership or LLC;
  - Rights in their individual share of the partnership or LLC;
  - Rights to participate in management are determined by organizational documents.

Who Has the Authority to File a Voluntary Bankruptcy Petition on Behalf of a Partnership or LLC?

- Generally, a person who files a voluntary bankruptcy petition on a partnership's or LLC's behalf must be authorized to do so under the entity's constituent documents or applicable state law.
- May need affirmative vote or written resolution, which authorizes the person who signs the bankruptcy petition on the entity's behalf to do so.

Involuntary Bankruptcy Petitions Against Partnerships

- An *involuntary* Chapter 7 or Chapter 11 bankruptcy case may be filed against a partnership by:
  - fewer than all of the general partners in such partnership; or
  - if bankruptcy relief has been ordered with respect to all of the general partners in the partnership, by a general partner in the partnership, the trustee of such general partner, or a holder of a claim against such partnership.
- See Section 303(b)(3) of the Bankruptcy Code.
- A general partner in a partnership debtor that did not join in the involuntary petition may contest an involuntary petition against the partnership. See Section 303(d).

The Bankruptcy Code's Different Definition of "Insolvent" for Partnerships

- 11 U.S.C. § 101(32): The term "insolvent" means
- With reference to an entity **other than a partnership** and a 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, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and
  - property that may be exempted from property of the estate under section 522 of the Bankruptcy Code.

The Bankruptcy Code's Different Definition of "Insolvent" for Partnerships (cont'd)

- With reference to a **partnership**, financial condition such that the sum of such partnership's debts is greater than the aggregate of, at a fair valuation:
  - all of such partnership's property, exclusive of property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and
  - the sum of the excess of the value of **each general partner's non-partnership property** (exclusive of property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and property that may be exempted from property of the estate under section 522 of the Bankruptcy Code), over such partner's non-partnership debts.

Property of the Estate

- The filing of a bankruptcy petition results in the creation of a bankruptcy "estate," comprised of all the legal and equitable rights and interests belonging to the debtor. See 11 U.S.C. § 541(a).
  - There are exceptions that are stated in Section 541(b).
- In principle, the bankruptcy estate of a partner/LLC member includes the individual partner/member's interest in the partnership or LLC, as well as any contractual rights belonging to the partner or member *vis a vis* the partnership or LLC.
- Much of the bankruptcy case law in this area addresses the ways in which the would-be rights and interests of the estate intersect with the rights of the other partners/members and the partnership/LLC – which are not in bankruptcy.

Management of the Estate

- The affairs of the estate are managed either by the actual debtor as the “debtor in possession” (in most Chapter 11 cases) or by a bankruptcy trustee appointed by the bankruptcy court (in all Chapter 7 cases and in some Chapter 11 cases).
- Where a trustee is appointed, the trustee is the successor to all of the debtor’s property and contractual rights, and is the legal representative of the estate.
- The debtor in possession or a bankruptcy trustee, is a fiduciary. It is their responsibility to serve the estate for the benefit of its creditors.

Potential Dissolution of Partnership or LLC If a Partner or Member Files Bankruptcy Individually

- Under the Uniform Partnership Act, the filing of a bankruptcy petition by a partner generally dissolves the partnership.
- Relevant state laws governing LLC's also frequently provide for dissolution upon the filing of a bankruptcy petition by a member.
- These dissolution provisions often conflict with the goals and principles of federal bankruptcy law, which seeks to preserve all rights and interests of the estate for the maximum benefit of its creditors.
- There is disagreement among the courts with respect to whether dissolution provisions existing under state law should be enforced following a bankruptcy.

Inconsistent Decisions on Application of Dissolution Provisions

- *In re Minton Group*, 46 B.R. 222 (S.D.N.Y. 1986): finding that, under New York partnership law, the filing of a bankruptcy petition by any partner results on the dissolution of the partnership.
- *In re Modanlo*, 412 B.R. 715 (Bankr. D. Md. 2006): finding that filing of bankruptcy petition by member dissolved the LLC under Delaware statutory law, but that the bankruptcy trustee had effectively revived the LLC by amending its operating agreement.
- *In re Woskob*, 305 F.3d 177 (3d Cir. 2002): concluding Section 365(e)(1) of the Bankruptcy Code precluded the dissolution of a partnership following the filing of a bankruptcy petition by one of its partners.
- *In re Ninzo*, 175 B.R. 934 (S.D. Ohio 1994): finding automatic dissolution provision to be unenforceable under Bankruptcy Code Section 365 because it amounted to an *ipso facto* clause.

Executory Contracts

- Section 365(a) provides that a bankruptcy trustee may assume or reject **executory contracts**.
- The term "executory contract" is not defined in the Bankruptcy Code.
- Most courts follow the "Countryman" definition of executory contract, which provides that an executory contract is a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach, excusing performance of the other.
- If a contract is not executory, it cannot be assumed by a trustee or debtor-in-possession. *See, e.g.*, *In re Spectrum Information Technologies, Inc.*, 190 B.R. 741, 747 (Bankr. E.D.N.Y. 1996).

Are Partnership and LLC Agreements Executory Contracts?

- Courts vary on the issue of whether partnership and LLC agreements are executory contracts.
  - *In re Ehmann,* 319 B.R. 200 (Bankr. D. Ariz. 2005): noting that courts consider, in deciding whether the agreement is executory, whether there is "some material obligation owing to the company by the member."
  - *In re Prebul*, 2011 WL 2947045 (Bankr. E.D. Tenn. Jul. 19, 2011): commenting that "[w]here the operating agreement imposes no duties or only remote and hypothetical duties, it is not an executory contract" and "where the operating agreement both requires ongoing capital contributions and imposes management duties, it has often been deemed executory."
  - *In re Allentown Ambassadors, Inc*., 361 B.R. 422 (Bankr .E.D. Pa. 2007): providing that "[i]n this inquiry, the four corners of the parties' agreement are examined to determine whether both parties have material, unperformed obligations as of the commencement of the bankruptcy case."

Assignment of Executory Contracts

- Section 365(c)(1) prohibits a trustee from assuming and assigning an agreement if non-bankruptcy law excuses the non-debtor party from accepting performance from any entity other than the debtor.
- For example, if a non-debtor entered into a contract with a debtor for personal services (e.g. painting their house), and state law prohibits the transfer of that contract, that contract cannot be assigned by the debtor or debtor in possession.
- State law often prohibits the assignment of operating and partnership agreements.
- Courts will consider the particular facts and circumstances when analyzing the assignability of a partnership or LLC agreement.
- *In re Antonelli*, 148 B.R. 443 (D. Md. 1992): calling for "particularized, practical approach" as to whether management power in partnership is assignable.

Ipso Facto Contract Clauses

- *Ipso facto* contract clauses purport to terminate, or place limitations on, a member's or partner's interest automatically as the result of the partner's or member's bankruptcy petition.
- They are generally unenforceable. See 11 U.S.C. § 365(e)(1)
- Section 365(e)(1): "Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on:
  - the insolvency or financial condition of the debtor at any time before the closing of the case;
  - the commencement of a case under the Bankruptcy Code; or
  - the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement."

Ipso Facto Contract Clauses (cont'd)

- *LaHood v. Covey*, 437 B.R. 330 (Bankr. C.D. Ill. 2010): provisions which purported to limit the members interest as a result of his bankruptcy filing were in violation of specific provisions of the Bankruptcy Code, and were therefore unenforceable.
- *In re Dixie Management & Inv., Ltd. Partners*, 2011 WL 1753971 (Bankr. W.D. Ark. 2011): disassociation provision in operating agreement conflicted with Section 541 of the Bankruptcy Code and was therefore unenforceable.
- *In re Tsiaoushis*, 383 B.R. 616 (Bankr. E.D. Va. 2007): operating agreement was not an executory contract, and so *ipso facto* prohibitions of Section 365 did not apply.

Are Withdrawal Provisions Enforceable?

- Applicable state law, and/or provisions of the partnership or an operating agreement, may provide that any partner or member who files for bankruptcy automatically withdraws from the partnership.
- However, Section 365(e)(1) of the Bankruptcy Code prohibits *ipso facto* clauses, and Section 541(c) provides that debtor’s property interest becomes property on the estate notwithstanding any contractual provision conditioned on the commencement of a case.

Are Withdrawal Provisions Enforceable? (cont'd)

- Enforceability of such provisions unclear.
- *Skeen v. Harms*, 10 B.R. 817 (Bankr. D. Colo. 1981): finding that, where the general partner in a limited partnership becomes a debtor in possession, there is "an inherent conflict of interest" because his fiduciary duty is no longer to the partnership, but rather to the bankruptcy estate.
- *In re Sovereign Group*, 88 B.R. 325 (D. Colo. 1988): distinguishing *Harms* and finding that the plan or reorganization should be amended to reflect the impaired partnership interest, and to ensure that it complies with the terms of the partnership agreement.

Compelling Policy Reasons for Enforcing Withdrawal Provisions

- Partners and members voluntarily associated in the business.
- Partnerships/LLCs may be the result of unique personal contacts.
- Partnerships/LLCs are often closely held.
- Bankruptcy case may create competing interests, and conflict between goals of managing the estate, and the goals of the partnership/LLC.

Rights of First Refusal in Partner/Member Bankruptcies

- Rights of first refusal may be provided by the partnership or operating agreement, and may offer individual partners or members the "first crack" at purchasing a particular asset.
- They are generally enforceable, **<u>unless</u>** they are triggered by the bankruptcy – in which case they are unenforceable *ipso facto* clauses.
- *In re Todd*, 118 B.R. 432 (Bankr. D.S.C. 1989): finding partner's right to match price offered for sale of partnership interest to third party was valid and enforceable under the Bankruptcy Code.
- *In re The IT Group, Inc., Co.*, 302 B.R. 483 (D. Del.): finding default provision which purported to provide other members with right to purchase debtor's membership interest upon the filing of a bankruptcy to be an unenforceable *ipso facto* provision.

Transfer of Economic Interests in Partnership or LLC

- Because the debtor’s economic interest in a partnership or LLC is property of the estate pursuant to Section 541 of the Bankruptcy Code, that interest is also generally transferrable.
- *Baldwin v. Wolff*, 690 N.E.2d 632 (App. Ct. Ill. 1998): concluding trustee could assign limited partner’s interest in partnership distributions.
- However, the rights transferred remain subject to the requirements of the agreement or other applicable law.
- *In re Dean*, 174 B.R. 787 (Bankr. E.D. Ark. 1994): holding contractual restrictions were not invalidated by the Bankruptcy Code.

Buy-Out Provisions

- Partnership or operating agreements may include “buy-out” provisions that permit other partners to purchase a debtor’s partnership interest upon the filing of a bankruptcy petition.
- It is unclear whether such a provision constitutes an *ipso facto* clause prohibited by the Bankruptcy Code.
- Most courts have concluded that buy-out provisions are enforceable in bankruptcy, unless they are written in such a way as to constitute a forfeiture, modification or termination of the debtor’s contractual rights. E.g., where the buyout is for less than market value.
- *In re Catron*, 158 B.R. 629 (E.D. Va. 1993): finding Bankruptcy Code did not invalidate buy-out provision.
- *Connally v. Nuthatch Hill Assocs.*, 831 F.2d 205 (10th Cir. 1987): Remanding to determine whether terms of the proposed buy-out would render it an *ipso facto* clause.

Buy-Out Provisions (cont'd)

- If the buy-out provisions fixes the buy-out price, it may be unenforceable. *See In re Cutler*, 165 B.R. 275 (Bankr. D. Ariz. 1994).
- Especially if the buyout price is below fair market value.
- So while buy-out provisions are (in theory) enforceable post-bankruptcy, they are subject to certain limitations imposed by the Bankruptcy Code. *See In re Grablowsky*, 180 B.R. 134 (Bankr. E.D. Va. 1995).

Possible Extension of Automatic Stay to General Partners or LLC Members Personally

- The filing of bankruptcy by a partnership or an LLC results in the automatic stay of actions against only the entity itself. The automatic stay does not apply to the *individual partners or members* themselves.
- However, Section 105 of the Bankruptcy Code provides that the court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of the Bankruptcy Code.
- Partners or members may ask the court to extend the automatic stay to them individually, by arguing various theories such as:
  - They are a potential source for funding a Chapter 11 plan of the partnership or LLC.
  - Any time that the partners or LLC members must spend in defending claims against them personally is time that they could otherwise devote to assisting in the debtor's reorganization.

Cancellation of Debt Income For Partners Resulting From Cancellation of the Partnership's Debt

- Cancellation of Indebtedness Income (“COD Income”):
  - Cancellation of Debt by Lender;
  - Cancellation of Debt by Operation of Law;
  - Substantial Modification of Debt;
  - Acquisition of Debt by related party
- COD Income is included in gross income unless an exception applies.

Section 108 Exclusions to Gross Income

- Section 108 of the Internal Revenue Code contains various exceptions to the inclusion of COD Income. These include any amount which would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if:
  - (A) the discharge occurs in a title 11 case,
  - (B) the discharge occurs when the taxpayer is insolvent,
  - (C) the indebtedness discharged is qualified farm indebtedness,
- The amount excluded under the insolvency exclusion may not exceed the amount by which the taxpayer is insolvent.

COD Income of a Partnership

- Income passes through to partners.
- Partner's basis in the partnership interest is increased by partner's share of COD Income.
- Partner's decrease in share of partnership liabilities is treated as a distribution of money to the partner.
- In a partnership, the partner recognizes a pro rata share of COD Income in full and applies Section 108 at the partner level.
  - The IRS has permitted partners to include excess nonrecourse debt of the partnership (to the extent the partnership nonrecourse debt is cancelled) in determining the partners' insolvency.
- In contrast, COD Income in an S corporation is recognized at the corporate level, where the taxable portion after the application of Section 108 is realized and passed through to the shareholders.

Partnership Interest for Debt Exception

- If a partnership transfers a partnership interest to a lender in satisfaction of debt, the partnership is treated as having satisfied the debt with an amount equal to the fair market value of the partnership interest.
- Thus, there is COD Income if the amount of the debt discharged exceeds the fair market value of the partnership interest.
- Any such COD Income is included in the distributive shares of the partners who were partners immediately before the issuance of the interest to the lender.

Bankruptcies of Individual Partners and LLC Members

- Bankruptcy Code focuses primarily on bankruptcy filings by individuals and entities.
- It does not address the issues arising from the bankruptcy filing of an individual member of an LLC, or an individual partner of a partnership.
- Such issues are addressed by case law, and include:
  - What are the estate's interests?
  - Does the filing dissolve the partnership or LLC?
  - What, if any, rights does the partner or member retain?
  - What, if any, effect does Section 365 have on partnership and LLC agreements
  - Effect of bankruptcy on right of first refusal; and
  - Applicability of buy-out provisions in bankruptcy.

What Rights of a Bankrupt Partner / LLC Member Transfer to That Individual's Bankruptcy Estate?

- No clear, universal answer to whether and how a member/partner's pre-bankruptcy petition rights and interests transfer to, and are exercisable by, the estate.
- Decided by the intersection of state law and federal law.
- Courts have found that the *economic* interest of the partner or member transfers to the estate pursuant to Bankruptcy Code Section 541. *See In re Garrison-Ashburn, L.C.* 253 B.R. 700 (Bankr. E.D. Va. 2000) (there is no question that the economic rights . . . become property of the estate).
- However, courts have also found that the interest as transferred to the estate will be encumbered by the requirements of state law. *See Northwest Wholesale, Inc. v. ac Organic Fruit LLC*, 184 Wash. 2d 176 (Wash. 2015).

Effect of Bankruptcy Petition on Rights of Partner / LLC Member

- Management and contractual of the bankrupt partner/member are often disputed following the filing of that partner/member's bankruptcy petition.
- For example, the filing of a bankruptcy by a partner/member could result in the dissolution or termination of his or her interest, and may preclude the debtor in possession/bankruptcy trustee from assuming contractual rights the partner or member might otherwise have with respect to the partnership/LLC.
- This includes any would-be management rights.

Implication of Transfer of Management Rights to Partnership or LLC

- Distinction between transfer of the debtor's **economic** interest to the estate (i.e., the value his or her share of the partnership or LLC), and the debtor's **management** interest with respect to the partnership or LLC.
- Where a court concludes that the management interest has transferred, this can provide the debtor in possession or bankruptcy trustee with some or complete control over the affairs of the partnership or LLC.
- *In re Albright*, 291 B.R. 538 (Bankr. D. Colo. 2003): finding that the bankruptcy trustee controlled management of the LLC because there were no other members besides the debtor.
- *In re Mondanlo*, 412 B.R. 716 (Bankr. D. Md. 2006): finding bankruptcy trustee could participate in management, but finding result may be different where there is more than one member.

Factors Concerning Potential Transfer of Management Rights to the Estate

- What does the operating or partnership agreement provide?
- Provisions of applicable state law.
- Whether other members can be compelled to accept performance by the trustee or debtor in possession.
- What does the relevant case law in that particular jurisdiction hold?
- Does any other member or partner object?
- Is there anything unique about the specific partnership or LLC which may render transfer impossible or impracticable?

Actual Intent Fraudulent Transfer Claims Against Partners / LLC Members

- Transfers from the partnership or LLC to individual partners / members might be avoided as fraudulent transfers.
- Elements of **actual intent** fraudulent transfer claims under Section 548(a) of the Bankruptcy Code:
  - The transferred assets were property of the partnership/LLC;
  - The property was transferred within the prescribed period of time before the bankruptcy (usually up to 4 years); and
  - The partnership / LLC made the transfer with the intent to hinder, delay or defraud its creditors.

Constructive Fraudulent Transfer Claims Against Partners / LLC Members

- Elements of **constructive** fraudulent transfer claims under Section 548(a) of the Bankruptcy Code:
  - The partnership / LLC had an interest in the property;
  - The property was transferred within the prescribed period of time before the bankruptcy (usually up to 4 years);
  - The partnership / LLC received less than reasonable equivalent value from the partner / member in exchange for the transfer; and
  - At least one of the following statements on the next slide is true with respect to the partnership or LLC:

Constructive Fraudulent Transfer Claims Against Partners / LLC Members (cont'd)

- The partnership / LLC 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;
- The partnership / LLC 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;
- The partnership / LLC 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
- The partnership / LLC made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

Fraudulent Transfer Claims Against Partners in the Law Firm Partnership Context. The "Jewel" Doctrine.

- Unfinished business theory / "Jewel" doctrine:
- Named after *Jewel v. Boxer*, 156 Cal. App. 3d 171 (Cal. App. 1st Dist. 1984), which involved a failed small law firm. The *Jewel* court held that in the absence of an agreement to the contrary, attorneys' fees received on cases in progress upon dissolution must be shared by the former partners of the failed firm.
- Relying on the *Jewel* doctrine, bankruptcy trustees of bankrupt law firm partnerships have sued the law firms to which partners of a failed firm moved.
- The bankruptcy trustees would claim a property interest (on behalf of the failed firm) against the new firms in the hourly fee matters that the partners had transferred from the failed firm to the new firm.

Fraudulent Transfer Claims Against Partners in the Law Firm Partnership Context. The "Jewel" Doctrine.

- An unfinished business or *Jewel* waiver is an agreement among the partners to disclaim any interest of the partnership in pending matters.
- Brobeck, Phleger & Harrison LLP: Partnership amended its partnership agreement, which was governed by California law, to include a *Jewel* waiver, which specified that "neither the Partners nor the Partnership shall have any claim or entitlement to clients, cases or matters ongoing at the time of the dissolution of the Partnership other than the entitlement for collections of amounts due for work performed by the Partners and other Partnership personnel on behalf of the Partnership prior to their departure from the Partnership."
- The bankruptcy court in Brobeck's bankruptcy case held that the agreement was a constructive fraudulent transfer because the partners had entered into it at a time when Brobeck was about to dissolve and was insolvent. *Greenspan v. Orrick, Herrington & Sutcliffe LLP* (*In re Brobeck, Phleger & Harrison, LLP*), 408 B.R. 318, 327 (Bankr. N.D. Cal. 2009).
- Ruling applied even to hourly fee work that was completed at a new firm.

Fraudulent Transfer Claims Against Partners in the Law Firm Partnership Context. The "Jewel" Doctrine.

- The New York Court of Appeals sided with the former partners and their new firms, when they were confronted with a bankruptcy trustee's claim under the *Jewel* doctrine with respect to hourly fee work that was completed post-dissolution.
  - *In New York, clients have always enjoyed the 'unqualified right to terminate the attorney-client relationship at any time' without any obligation other than to compensate the attorney for 'the fair and reasonable value of the completed services.' … In short, no law firm has a property interest in future hourly legal fees because they are 'too contingent in nature and speculative to create a present or future property interest.'"*
  - *In re Thelen LLP, 20 N.E.3d 264, 270 (N.Y. 2014)*.

Fraudulent Transfer Claims Against Partners in the Law Firm Partnership Context. The "Jewel" Doctrine.

- The California Supreme Court held that the estate representative had no viable claim under the *Jewel* doctrine for hourly fee work that was completed post-dissolution at a new firm.
  - *While Heller was a viable, ongoing business, it no doubt hoped to continue working on the unfinished hourly fee matters and expected to receive compensation for its future work. But such hopes were speculative, given the client's right to terminate counsel at any time, with or without cause. As such, they do not amount to a property interest.*
  - *Heller Ehrman LLP v. Davis Wright Tremaine LLP, 411 P.3d 548, 555 (Cal. 2018).*

- The D.C. Court of Appeals in the *Howrey* case also agreed that the *Jewel* doctrine does not apply in the context of unfinished hourly fee work.

Uniform Voidable Transactions Act: Background

- New York recently enacted the Uniform Voidable Transactions Act (UVTA)
- The law was the result of lobbying by the City Bar Association based on the work of the Bankruptcy Committee and the Commercial Law and Uniform Laws Committee started approximately five years ago
- Becomes effective for transactions on and after April 4, 2020
- New York currently has a version of the Uniform Fraudulent Conveyance Act (UFCA) enacted back in 1925
- New York never adopted the Uniform Fraudulent Transfer Act (UFTA), promulgated in 1984 as a replacement for the UFCA, designed to be similar to the fraudulent conveyance provision of the Bankruptcy Code

Uniform Voidable Transactions Act: Background (cont'd)

- The only state remaining with a version of the UFCA is Maryland.
- 21 states so far have enacted the UVTA, including New York, 24 states have the UFTA, Maryland has the UFCA and four states have none of these (the four which don't have UVTA, UFCA or UFTA are Alaska, Louisiana, South Carolina and Virginia)
- UFTA is essentially a replacement for the UFCA, and not an amendment
- UVTA is viewed as an amendment to the UFTA—so it is a big change for New York

Uniform Voidable Transactions Act: Background (cont'd)

- UVTA will take effect in New York on April 4, 2020 for transactions occurring on and after that date
- The two statutory regimes will coexist for years
- Where potentially voidable transactions fall on both sides of that date, lawsuits will need to assert causes of action under each
- UFCA causes of action could be brought for many years--not just six years from the day before the effective date--but even ten if by a bankruptcy trustee is using his or her ability to step into the shoes of the IRS under the IRC avoidable transactions provision which has a ten year statute of limitations, or even more if the two-year discovery rule for intentional fraudulent conveyances applies.

Uniform Voidable Transactions Act: Changes to Existing Law and Choice in Law

- Current UFCA/NY DCL: The NY DCL does not currently provide a provision for choice of law.
- Controlling law is determined on a case-by-case basis by case law or by non-statutes.
- The new UVTA: A claim under the UVTA is controlled by the law where the debtor is located at the time of the voidable transaction (NY DCL § 279(b)).

Uniform Voidable Transactions Act: Changes to Existing Law and Choice in Law (cont'd)

- It is more simple and to the point to base choice of law on the location of the debtor/transferor
- Applicable law will be decided by the state of its sole place of business or its chief executive office if it has multiple places of business
- The result of these changes will be more predictable outcomes than the previous multi-step choice of law analysis
  - NOTE: The rules for determining where a debtor is located under Section 10 of the UVTA has similar application to those for determining where a debtor is located for perfecting security interests under Article 9 of the Uniform Commercial Code.

Uniform Voidable Transactions Act: Changes to Existing Law and Choice in Law (cont'd)

- Depending on what law held to apply to, confusion and disparate results could ensue due to inconsistencies between the current law of the Bankruptcy Code and the 44 states that have enacted the UFCA or UFTA
- These differences and system miscommunications often fueled costly litigation over choice-of-law issues

Statute of Limitations/Repose

- Current UFCA:
  - 6 years for a creditor to challenge an allegedly voidable transaction, or
  - 2 years from when a plaintiff "discovered or could have with reasonable diligence have discovered" an intentionally fraudulent transfer
  - whichever is later applies
- Under the new UVTA:
  - 4 years for a creditor to challenge an allegedly voidable transaction, or
  - 1 year from when a plaintiff "discovered or could reasonably have discovered" an intentionally fraudulent transaction
  - Also under the new UVTA: 1 year for a creditor to challenge a payment to an insider on an antecedent debt when insider had reasonable cause to believe the transferor was insolvent (the new insider preference statute—discussed below)

Statute of Limitations/Repose (cont'd)

- Rather than a statue of limitations, the UVTA has a statute of repose
  - Statute of repose: a statute that extinguishes a cause of action if not presented in a timely manner. Timeliness is an element of the cause of action.
- A statute of limitations sets a lawsuit-filing time limit that may, if the defendant chooses to asserted it, be an affirmative defense. Accordingly, it will be waived if not timely asserted.
- A statute of limitations is subject to equitable and contractual tolling.
- A statute of repose is not subject to equitable tolling and query if it can be subject to a tolling agreement? If it can be "extended" by agreement, for the tolling to be effective, that cause of action might have to be converted to a contract cause of action under the tolling agreement.

Burdens of Proof and Persuasion

- Current UFCA: As determined by case law –
  - “clear and convincing proof” for intentional fraudulent conveyances; and “preponderance of the evidence” for constructive fraudulent conveyances.
- Under the new UVTA: Set forth in the statute –
  - “preponderance of evidence” on all causes of action and affirmative defenses.
- The statute now specifies these burdens.
- Query whether existing case law presumptions will still apply, such as the one where insolvency is presumed when a conveyance made without fair consideration?

Elimination of Good Faith as an Element of Value Exchanged

- Current UFCA: A transferee's intent is relevant when determining whether a transfer was voidable. While considering if a transfer was made for "fair consideration," the UFCA required that the exchange be proportionate in value and made in good faith.
- Under the new UVTA: A transferee's intent is not relevant when determining if the transaction is voidable. Instead, the transferee's "good faith" is only relevant when asserting an affirmative defense to a claim of voidable transfer.
  - The UVTA focuses on the overarching goal of fraudulent transaction law to protect creditors from the unfair diminution of a debtor's property. The underlying motivation of a transferee is not relevant to this goal.

Modification of the "Insider Preference"

- Current UFCA: There was previously no statutory predicate, but case law permitted avoidance of a transfer to an insider on an antecedent debt based on a presumption that the transfer was not made in "good faith" if the transferor was insolvent.
  - Insider would have to pay back a debt payment notwithstanding having given the transferor dollar for dollar consideration.
- Under the new UVTA: Allows for the avoidance of debt repayments made within one year to an insider by an insolvent transferor if the insider had "reasonable cause" to believe that the transferor was insolvent at that time.
- This no longer automatic—plaintiff must prove that an insider had reasonable cause to believe transferor was insolvent at time of transfer.
- UVTA contains an ordinary course and additional new value defense like those Bankruptcy Code preference defenses.
- Query whether a transfer to a fully secured insider creditor is avoidable, as nothing in the statute seems to indicate it would not be.

Defenses Available to Initial and Subsequent Transferees: Current UFCA

- Current UFCA: A defendant acted in good faith and that provides "value" in exchange for the transfer/obligation in question will typically be protected under the current law, up to the amount of value given.
  - This includes subsequent transferees.
- Current New York Law: provides that a "purchaser who without actual fraudulent intent has given less than a fair consideration for the conveyance or obligation, may retain the property or obligation as security for repayment." (Debtor & Creditor Law § 278(2)).
  - It also provides that a creditor cannot proceed against "a purchaser for fair consideration without knowledge of the fraud at the time of purchase." (Debtor & Creditor Law § 278(1)).

Defenses available to Initial and Subsequent Transferees: Under New UTVA

- Under the new UTVA: A transfer or obligation is not voidable against transferees who took in for reasonably equivalent value and in good faith. It is not voidable as to any subsequent transferee. (Debtor & Creditor Law § 277(a)).
- The new UVTA clarifies and enhances the protections and defenses available to initial and subsequent transferees who had no prior knowledge of the transferor's impaired financial condition.
- The new UVTA also introduces a credit available to transferees for amounts paid for or expended to improve the property in question. Under section 277(d) of the UVTA, notwithstanding a transfer's voidability, to the extent of the value given to the debtor for the transfer, the good faith transferee is entitled to:
  - A lien or right to retain an interest in the asset transferred;
  - Enforcement of an obligation incurred; or
  - A reduction in the amount of the liability of the judgment.

Elimination of Constructive Fraudulent Conveyances Based On Pending Litigation

Current UFCA:

- If a defendant makes a transfer while litigation is pending without "fair consideration," it is voidable to the plaintiff in the litigation (not to other creditors)
- if the plaintiff obtained a judgment that was not satisfied and without consideration of the defendant's insolvency at the time of the transfer considered. NY UFCA 273-1.

Under the new UVTA:

- This provision is entirely eliminated, however, transfers by defendants are now a "badge of fraud" that can be relied on among other factors.
  - Such a badge of fraud can be used by any creditor and not just the creditor in the pending action to determine whether the defendant acted with actual intent to hinder, delay or defraud.

Provision for Recovery of Attorneys' Fees In Constructive Fraudulent Transactions Cases

- Current UFCA: allows for the court to award legal fees only in circumstances where a party can establish that a transaction was Intentionally fraudulent.
- Under the new UVTA as enacted in New York:
  Allows the court to award attorney fees in either an actual or constructive fraudulent conveyance action if plaintiff was entitled to fees based on the underlying cause of action that gave rise to the debt, whether by statute or contract
- There is no attorney fee provision in the Uniform UVTA

Elimination of Archaic Principles From Partnership and Secured Transaction Law

- The UVTA eliminates a provision of the UFCA which was applicable only to partnerships that made every transaction with a partner while the partnership is insolvent voidable as to creditors of the partnership, without any consideration as to the services that were provided in exchange for the transfer
- The previous law essentially operated to incentives partners to not continue operating partnerships in financial distress (e.g., Dewey & LeBeouf), as such, partnerships are now subject to the same provisions of the UVTA as other entities.

Elimination of Archaic Principles From Partnership and Secured Transaction Law (cont'd)

- The UVTA eliminates the excess collateral issue
- Under current New York law, the determining factor of fair value for a grant of a security interest is whether the debt being secured is "disproportionately small" when compared to the value of the collateral subject to the security interest.
- The UVTA finds this evaluation as unnecessary and inconsistent with the modern law of security interests that adequately protects the debtor's interest in the residual value of any excess collateral granted a secured creditor.

Thank You!

Michael J. Riela

(212) 508-6773

riela@thsh.com

Richard W. Trotter

(212) 508-7542

trotter@thsh.com

Tannenbaum Helpern
Syracuse & Hirschtritt LLP

Disclaimer

The information presented in this presentation does not represent legal advice, which should come from a legal adviser with knowledge of specific facts and circumstances.

About Tannenbaum Helpern Syracuse & Hirschtritt LLP

Since 1978, Tannenbaum Helpern Syracuse & Hirschtritt LLP has combined a powerful mix of insight, creativity, industry knowledge, senior talent and transaction expertise to successfully guide clients through periods of challenge and opportunity. Our mission is to deliver the highest quality legal services in a practical and efficient manner, bringing to bear the judgment, common sense and expertise of well trained, business minded lawyers. Through our commitment to service and successful results, Tannenbaum Helpern continues to earn the loyalty of our clients and a reputation for excellence. For more information, visit www.thsh.com.

900 THIRD AVENUE, NEW YORK, NY 10022 • 212-508-6700 • WWW.THSH.COM • Twitter: @THSHLAW

Providing Solutions®

