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The Trustee's Power to Avoid Fraudulent Transfers

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Editors' Note: *Bankruptcy law gives a bankruptcy trustee or debtor-in-possession (DIP) the power to avoid certain transfers and transactions that took place before the bankruptcy. The most common avoidance powers are (1) the power to avoid preferences, (2) the power to avoid fraudulent conveyances and (3) the trustee's "strong-arm" power. Last month's column focused on the trustee's ability to avoid preferences. This month's column focuses on the trustee's power to avoid fraudulent conveyances and "strong-arm" powers.*

Fraudulent transfer law is old. The precursor to our modern fraudulent conveyances law dates back to the Statute of Elizabeth, enacted in England in the 16th Century. It was designed to protect creditors against debtors that would thwart collection efforts by giving away their property with the hopes of having it reconveyed after discouraged creditors gave up on collecting their claim. Case law history dating back to the 17th Century continues to be relevant. Indeed, current statutes can best be understood as crystallizing a lot of this long case-law history.

Today in the United States, every state has its own fraudulent conveyance law, which is applicable outside of bankruptcy as well as in bankruptcy. In addition, the Bankruptcy Code contains its own fraudulent conveyance law, codified in §548 of the Code, which applies only in bankruptcy cases. The Uniform Fraudulent Transfer Act (UFTA) is the applicable state fraudulent conveyance law of all but about five states. New York is the most important exception. The UFTA in many respects parallels Code §548, although the two are not identical. The remaining five states retain the old Uniform Fraudulent Conveyance Act (UFCA).

The trustee or DIP essentially must show the following elements in a fraudulent conveyance action under §548:

> A transfer, either voluntary or involuntary, of the debtor's property or an interest therein (including the incurring of an obligation by the debtor);
>
> 1. made (or incurred) within one year before the date of the filing of the bankruptcy petition, and *either*
> (a) made (or incurred) with actual intent to hinder, delay or defraud a creditor of the debtor (sometimes referred to as "actual fraud"), or
> (b) for which the debtor received less than reasonably equivalent value, *and* (i) the debtor was insolvent when the transfer was made (or obligation incurred) or was rendered insolvent hereby, *or* (ii) the debtor was engaged (or was about to become engaged) in a business for which the debtor's remaining property represented an unreasonably small capital, *or* (iii) the debtor intended to incur (or believed he or she would incur) debts beyond his or her ability to repay as they matured (sometimes referred to as "constructive fraud").

Avoidance actions must be commenced under §548 before the *later* of two years after the entry of the order for relief (the date of the bankruptcy filing in voluntary cases) or one year after a trustee is appointed, if the appointment occurs before the expiration for the original two-year period.

Bankruptcy Rule 7001(2) requires the plaintiff to bring a fraudulent transfer avoidance cause of action as an adversary proceeding. The plaintiff has the burden of making a *prima facie* case. Insolvency must be proven by the plaintiff; unlike in a preference action, insolvency is not presumed. The standard of proof is a preponderance of the evidence; intent to defraud, however, must be proven by clear and convincing evidence.

Actual Intent vs. Reasonably Equivalent Value

As indicated above, the trustee has the ability to avoid two different kinds of transfers: (1) transfers made with actual fraud (under §548(a)(1)(A)), or (2) transfers that involve constructive fraud (§548(a) (1)(B)). The distinction between the two is important. It is important in practice, because the *prima facie* showing required for each type of case is different. It is important in principle because it exhibits the different policies that underlie fraudulent transfer law.

The trustee is free to proceed under either prong of the fraudulent conveyance law. Thus, if the trustee can show insolvency and less-than-reasonably equivalent value, then he doesn't have to show actual intent. For example, if the debtor gives away any of his property while he is insolvent, the trustee may avoid the transfer without any showing of intent. Alternatively, if the trustee can show that the debtor intended to hinder, delay or defraud, then he may avoid the transaction without any showing as to solvency.

The trustee is perfectly free to "plead in the alternative," and there are cases where the two classes overlap: A debtor who gives away property while insolvent may well have the intent to hinder, delay or defraud creditors. Moreover, there may be a fine line between "intend[ing] to incur debts beyond his ability to pay" and "actual intent to hinder, delay or defraud" a creditor.

What Is a Transfer?

So far, we have spoken of "transfers," but we have not defined transfers. Of course, a conveyance of real or personal property can be a "transfer," and that is the most common case. For example, a deed to real property or a payment of cash is a "transfer." But there are less obvious sorts of "transfers" as well. For example, the granting of a release or waiving of claims may be a transfer. Terminating a license could be a "transfer." And some courts have held that making a tax election that results in a loss of valuable tax attributes constitutes a transfer. Thus, it makes sense to think broadly when considering what may constitute a transfer for purposes of fraudulent conveyance analysis—anything that results in a loss of value to the transferor, whether intentionally or not, may qualify.

In fact, the Code's definition is more extensive than just transfers. It says the trustee "may avoid any transfer of an interest of the debtor in property." But then it adds the phrase "or any obligation incurred." So a *promise to transfer* money or property may be avoidable, just as much as a transfer itself.

Proving Intent

It is usually difficult to find good, non-circumstantial evidence of "actual intent to hinder, delay or defraud." People do not tend to admit such "evil" intent, and other "hard evidence" of intent is hard to come by. Recognizing this, the UFTA includes a list of conditions or events that are suggestive of fraudulent intent. These are referred to as "badges of fraud." UFTA §4(b) provides that "in determining actual intent under subsection (a)(1), consideration may be given, among other factors, to whether:"

1. the transfer or obligation was to an insider;
2. the debtor retained possession or control of the property transferred after the transfer;
3. the transfer or obligation was disclosed or concealed;
4. before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
5. the transfer was of substantially all the debtor's assets;
6. the debtor absconded;
7. the debtor removed or concealed assets;
8. the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;
9. the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
10. the transfer occurred shortly before or shortly after a substantial debt was incurred; and
11. the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

And while these factors are not specifically included in §548, many judges consider them in fraudulent transfer actions under the Bankruptcy Code, as well as under the UFTA. The "badges of fraud" point to an important conceptual difficulty in fraudulent transfer law, which is: We are talking about "actual" intent. Yet by including the badges of fraud, the drafters implicitly concede that we *rarely* know the transferor's *actual* intent; in most cases, the best we can do is to infer the transferor's intent from some outward signs.

Good-faith Transferees and Charitable Contributions

A transferee who deals at arm's length with his transferor may be protected by a "good-faith transferee rule." Specifically, §548(c) provides that a transferee, who takes for value and in good faith, has a lien on the property transferred (or may retain property transferred) to the extent of the value he gave for the transfer. For example, a good-faith purchaser buys a house for $300,000. The seller then files bankruptcy and sues the buyer under §548 to avoid the sale as a fraudulent conveyance, arguing that the seller was insolvent at the time of the sale and that the house was actually worth $1 million. The transaction will be avoided, since the seller did not receive reasonably equivalent value, but the buyer will retain a lien on the house, after it is reconveyed to the seller's estate, to secure its $300,000 purchase price. (If the buyer made improvements to the house before he reconveyed it, he may also have a lien to secure the value of the improvements he made, pursuant to §550(e)).

Good faith requires an arm's-length transaction and the following three factors:

1. a belief in the propriety of the actions in question;
2. no intent to unconscionably disadvantage others; and
3. no intent to, or awareness that, the activities in question will hinder, delay or defraud others.

Lienors and obligees, as well as good-faith purchasers, may be protected under this defense. Knowledge of the transferor's insolvency may prevent an assertion of good faith.

Another important exception relates to the case of charitable contributions. A charitable contribution would seem to be a gift, and if the debtor makes the charitable contribution while insolvent, you might think it would be avoidable under the "constructive fraud" rule. This is not necessarily so per §548(a)(2), which insulates certain charitable contributions from fraudulent transfer attack. But note that it does not exempt charitable contributions made with actual intent to hinder, delay or defraud creditors.

"Strong-arm" Avoidance Under §544(b)

Aside from §548, there is a wholly separate line of attack for the trustee trying to avoid a fraudulent transfer. This is §544(b) of the Code, which provides that the trustee may avoid a transfer "that is voidable under applicable law by a creditor holding an unsecured claim." This means that the trustee may look to non-bankruptcy law (usually "state" law) and deploy any avoiding power that he finds there. The most common use of §544(b) is to give the trustee a right of action under state fraudulent transfer law, the UFTA or UFCA. These are most often useful to the trustee (or DIP) because of the longer reach-back period available under state law. As noted above, under §548 a trustee may avoid a fraudulent transfer only if it took place within one year prior to the petition date. However, depending on the state, the reach-back period under state law may be from two to six years.

There are occasionally other uses that a trustee can make of state fraudulent conveyance law—claims that exist under state law but not under §548. For example, under the UFTA a transfer by an insolvent debtor to an insider who knew of the insolvency, on account of a debt owed to the insider, may be avoidable, even though it would (absent actual fraud) not be avoidable under §548 because, under §548, "value" includes the satisfaction of an antecedent debt. This case may not come up every day, but it illustrates an important point: When considering a fraudulent conveyance action, the trustee (or DIP) should review the applicable state statute to determine what claims may be available. ■

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