

Schulte Roth & Zabel

The Association of Commercial
Finance Attorneys, Inc.

Fraudulent Conveyance Law:
Drafting Considerations and Techniques
to Avoid Pitfalls

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Introduction

- **As a result of lending policies that permitted the financing of leveraged buy-outs, leveraged dividends and similar transactions in the pre-financial crisis period, lenders increasingly became the targets of fraudulent conveyance litigation when the companies they financed later filed for bankruptcy**
- **While the statute of limitations on those transactions has now likely passed, the cases that were litigated have resulted in judicial decisions that provided guidance – and warnings– to lenders that should be heeded in future lending practices**

Typical Circumstances Giving Rise to Fraudulent Conveyance Challenges Involving Lenders

- **Leveraged Buyouts**
- **Guarantees (parent/subsidiary; subsidiary/parent; brother/sister subsidiaries)**
- **Co-borrowers**
- **Mandatory subordination of intercompany loans**
- **Mandatory conversion of intercompany loans to equity**
- **Waiver or deferral of rights to assert subrogation claims**

Fraudulent Conveyance Statutes

- **Purpose**
 - To put the debtor (and its creditors) back in their original positions through the recovery of assets (or their value) and/or the avoidance of liens and claims
 - Remedial, not punitive
 - Put creditors on same footing as other similarly-situated creditors
- **Two sets of potentially applicable statutes**
 - Section 548 of the Bankruptcy Code
 - State law (UFTA or UFCA, depending on the state), incorporated by Section 544 of the Bankruptcy Code

Fraudulent Conveyance Statutes

- **Section 548 provides that a transfer may be avoided if there is either:**
 - Actual Fraud
 - Transfer made or obligation incurred with actual intent to hinder, delay, or defraud creditors
 - Constructive fraud
 - Transfer made or obligation incurred will be deemed constructively fraudulent when it unfairly diminishes a debtor's assets to the detriment of other creditors
 - Focus is on the debtor's:
 - Financial condition at time of, and after giving effect to, the transfer made or obligation incurred, and
 - The value received by the debtor in exchange

Fraudulent Conveyance Statutes

- **Section 548(a)(1): Constructive fraud requires a showing that the debtor received less than “reasonably equivalent value” in exchange for the transfer made or the incurrence of the obligation; AND that the debtor:**
 - Was insolvent on the date the transfer was made or obligation incurred or became insolvent as a result of the transfer or incurrence;
 - Was left with “unreasonably small capital;”
 - Incurred or believed it would incur debts beyond its ability to pay when due; OR
 - Made the transfer or incurred the obligation to an insider or for the benefit of an insider, outside the ordinary course of business

Fraudulent Conveyance Statutes

- **Test is stated in the disjunctive, and thus a transfer made or debt incurred may constitute a fraudulent conveyance if the debtor received less than reasonably equivalent value and any one of the other criteria is satisfied.**
- **Section 548 provides a 2-year look-back period from commencement of the bankruptcy case**

Fraudulent Conveyance Statutes

- **Applicable state law (incorporated by Bankruptcy Code § 544)**
 - UFTA/UFCA
 - The Uniform Fraudulent Conveyance Act (UFCA) is the predecessor to the Uniform Fraudulent Transfer Act (UFTA).
 - UFTA introduced, among other things, avoidance of transfers to insiders, enhanced creditors' remedies against transferees, and new defenses.
 - UFTA operates in the vast majority of states.
 - UFCA operates only in a few states, including New York

Fraudulent Conveyance Statutes

- **New York fraudulent conveyance law (N.Y. Code – Article 10)**
 - **Actual Fraud** (N.Y. Debtor and Creditor Law § 276)
 - “Every conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors, is fraudulent as to both present and future creditors.”

Fraudulent Conveyance Statutes

- **New York fraudulent conveyance law (N.Y. Code – Article 10)**
 - **Constructive Fraud** (N.Y. Debtor and Creditor Law §§ 273, 274, 275)
 - § 273: where the transfer renders the debtor insolvent or an obligation is incurred without fair consideration.
 - § 274: where the debtor is left with unreasonably small capital.
 - § 275: where no fair consideration is given and where person making the conveyance or debtor entering into the obligation intends or believes that debtor will incur debts beyond his ability to pay

Fraudulent Conveyance Statutes

- **Applicable state law (incorporated by Bankruptcy Code § 544)**
 - Which state's law applies will depend on the facts and circumstances of each case
 - Statute of limitations dictated by state law (including by reference to the borrowing statute of the applicable state, which could result in a court applying one state's substantive law and another state's statute of limitations)
 - Generally 3 – 6 years
 - New York: 6 years

Fraudulent Conveyance Statutes

- **State law claims belong to individual creditors**

- Transferred to estate upon filing
- Can be prosecuted or abandoned by estate
 - *See, e.g., In re Tribune Co. Fraudulent Conveyance Litig.*, No. 11-MD-2296 (S.D.N.Y.)
 - *In re Lyondell Chem. Co.*, Nos. 10-4609, 10-5525, 12-1570 (Bankr. S.D.N.Y.)
 - *In re Boston Generating, LLC*, No. 12-1879 (Bankr. S.D.N.Y.)
 - *Whyte, as Trustee of the SemGroup Litigation Trust v. Barclays Bank PLC*, No. 13-2653 (2d Cir.)

Fraudulent Conveyance Law Applied to Leveraged Buyouts

- **Out-of-the-money creditors of a failed LBO company often are left looking for someone to blame**
- **Former shareholders are typically the defendants, but section 546(e) of the Bankruptcy Code may preclude recovery absent actual intent**
- **Fraudulent conveyance laws have also been used to target lenders that have financed a leveraged buyout**

Fraudulent Conveyance Law Applied to Leveraged Buyouts

- **The *Gleneagles* case set the stage for a boom in such litigation:**
 - The Third Circuit held that mortgages executed to a lender in connection with an LBO of a coal company were fraudulent conveyances under Pennsylvania law and invalidated the lender's liens. *U.S. v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986)
 - See also *Moody v. Sec. Pac. Bus. Credit, Inc.*, 971 F.2d 1056 (3d Cir. 1992); *In re Plassein Int'l Corp.*, 590 F.3d 252 (3d Cir. 2009); *Credit Managers v. Fed. Co.*, 629 F. Supp 175 (C.D. Cal. 1985); *Crowthers McCall Pattern, Inc. v. Lewis*, 129 B.R. 992 (S.D.N.Y. 1991); *Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488 (N.D. Ill. 1998).

Fraudulent Transfer Law Applied to Leveraged Buyouts

- **After a wave of such cases, fraudulent conveyance cases in the LBO context subsided**
- **The credit boom of the 2000's fostered many highly leveraged transactions**
- **The credit crisis then spawned a new surge of fraudulent conveyance litigation**

Fraudulent Transfer Law Applied to Leveraged Buyouts

- **Typically prosecuted by the estate (or a creditors' committee or trust acting on behalf of the estate) in Chapter 11 cases**
 - See, e.g., *In re Revco D.S., Inc.*, 118 B.R. 468 (Bankr. N.D. Ohio 1990) (preferred equity holder moved to bring suit derivatively on behalf of debtors to challenge LBO as fraudulent conveyance)
 - *In re Tribune Co. Fraudulent Conveyance Litig.*, 499 B.R. 310 (S.D.N.Y. 2013) (creditors' committee sued former shareholders and other beneficiaries of LBO to unwind transaction as fraudulent conveyance);
 - *In re Lyondell Chem. Co.*, 503 B.R. 348 (Bankr. S.D.N.Y. 2014) (creditors' trust sought to avoid payments made to former shareholders in connection with LBO);

Fraudulent Transfer Law Applied to Leveraged Buyouts

- *In re SemCrude, L.P.*, 2013 WL 2490179 (Bankr. D. Del. June 10, 2013) (trustee of litigation trust brought suit to avoid and recover partnership distributions made in connection with LBO);
- *Boyer v. Crown Stock Distribution, Inc.*, 587 F.3d 787 (7th Cir. 2009) (Chapter 7 trustee sought to recover transfers made to former shareholders in connection with LBO);
- See also *In re Tronox Inc.*, 503 B.R. 239 (Bankr. S.D.N.Y. 2013) (debtors brought suit against company from which they had been spun-off, alleging that spin-off was fraudulent conveyance designed to free defendants from massive environmental liability);
- *In re Mervyn's Holdings, LLC*, 426 B.R. 488 (Bankr. D. Del. 2010) (debtor brought claims against parent company which had divested itself of debtor).

Fraudulent Transfer Law Applied to Leveraged Buyouts

- **LBOs can be attacked as actually or constructively fraudulent**
 - Claims against lenders are generally those based on constructive fraud
 - However, in several recent cases claims of actual fraud have been levied at some or all of the lenders or their agents
 - *See, e.g., Tribune; Lyondell; Boston Generating; Chrysler*

Fraudulent Transfer Law Applied to Leveraged Buyouts

- **In many cases, the fraudulent conveyance action is prosecuted by one or more litigation trusts formed pursuant to the debtor's plan of reorganization.**
- **The beneficiaries of the trust appoint a “litigation trustee” to prosecute the action, and form a “trust oversight board”. Under the plan of reorganization, certain causes of action are transferred or “contributed” to the trust**
 - Estate causes of action under Bankruptcy Code sections 548 and 544
 - Individual creditor causes of action

Fraudulent Transfer Law Applied to Leveraged Buyouts

- **Recent decisions provide guidance to debtors and their creditors on how to structure these litigation trusts to avoid potential defenses to the claims under section 546 of the Bankruptcy Code**
 - Section 546(e) barred state law claims when claims were brought by creditor trust as "trustee" *and* on behalf of creditors.
 - *Whyte v. Barclays Bank PLC*, 49 B.R. 196 (S.D.N.Y. 2013)
 - Section 546(e) did not bar state law claims where trust created under plan was prosecuting solely individual creditors' state law claims that had been "contributed" to the trust.
 - *In re Lyondell Chem. Co.*, 503 B.R. 348 (Bankr. S.D.N.Y. 2014)

Intentional Fraudulent Transfer

- **Whose intent matters: transferor or transferee?**
 - Only transferor's intent matters
 - May be sufficient to show intent was simply to hinder or delay creditors; showing of intent to defraud not required
- **Court will look for “badges of fraud” such as:**
 - Transfer made to an insider
 - Transferor retained possession or control of property after transfer
 - Secrecy of the transaction in question
 - Deviation from the usual method or course of business

Intentional Fraudulent Transfer

- **In LBO cases, the court will also look to the reasonableness of the projections prepared by the proponents of the LBO**
 - If allegations of actual fraudulent transfer are made against the lenders, the court will also review the level of diligence conducted by the lender to determine if the lender “knew or should have known” of issues in the projections

Reasonably Equivalent Value/ Fair Consideration

- **Code § 548(a)(1)(B):** The trustee may avoid any transfer if the debtor “*received less than reasonably equivalent value in exchange for such transfer or obligation; and*”
- **What constitutes “reasonable” or “fair”?**
- **Factors considered**
 - Amount paid vs. fair market value
 - Good faith of the parties
 - Arms’ length nature of transaction
 - Need not be “dollar for dollar”

Reasonably Equivalent Value/ Fair Consideration

- **Direct versus indirect benefits**
 - Indirect benefits may be considered
 - Some courts have focused on the qualitative benefits received, while others emphasize the need for true quantitative benefits.
 - In the LBO context, the synergies to be obtained from the acquisition may constitute “reasonably equivalent value” as well as other indirect benefits such as goodwill and an increased ability to borrow working capital. See *Mellon Bank, N.A. v. Metro Commc’ns, Inc.*, 945 F.2d 635, 647 (3d Cir. 1991).
 - Indirect benefits to a guarantor can also exist where the guaranty may safeguard an important source of supply, or an important customer for the guarantor. See *Telefast, Inc. v. VU-TV Inc.*, 591 F. Supp. 1368, 1379 (D.N.J. 1984).

Reasonably Equivalent Value/ Fair Consideration

- **Guarantees**

- Downstream

- Typically upheld because parent derives benefit through its equity ownership from subsidiary's incurrence of debt and/or granting of liens

- Upstream/Sidestream

- Fraudulent conveyance risk
 - Savings clauses: in *TOUSA*, the Bankruptcy Court held that the savings clauses were unenforceable as an invalid attempt to circumvent the Bankruptcy Code. See *In re TOUSA, Inc.*, 422 B.R. 783, 863-65 (Bankr. S.D. Fla. 2009).

Reasonably Equivalent Value/ Fair Consideration

- ***In re TOUSA, Inc.*, 680 F.3d 1298 (11th Cir. 2012).**

- Facts

- Parent company obtained new loan to pay a settlement amount to prior lender
- New loan was secured, in part, by liens on assets of subsidiaries who were not liable on the original loan
- Shortly thereafter parent and subsidiaries filed chapter 11 petitions
- The creditors' committee, on behalf of the subsidiaries' estates, sued the new and old lenders
 - Committee sought avoidance and recovery of transfer to prior lender
 - Committee sought avoidance of new lenders' liens on the subsidiaries' assets

Reasonably Equivalent Value/ Fair Consideration

- **TOUSA**

- The bankruptcy court avoided the obligations incurred by the subsidiaries and the liens on the subsidiaries' assets. See *In re TOUSA, Inc.*, 422 B.R. 783 (Bankr. S.D. Fla. 2009).
 - Held that the subsidiaries did not receive reasonably equivalent value for the liens granted to lenders.
 - Rejected lenders' arguments that "indirect benefits" constituted reasonably equivalent value.
- The district court reversed, holding that "indirect, intangible, economic benefits, including the opportunity to avoid default, to facilitate the enterprise's rehabilitation, and to avoid bankruptcy" may be considered in determining reasonable equivalent value. See *In re TOUSA, Inc.*, 444 B.R. 613 (S.D. Fla. 2011)

Reasonably Equivalent Value/ Fair Consideration

- ***TOUSA***

- The court of appeals reversed the district court and found that the guarantees and liens issued by the subsidiaries were avoidable as fraudulent conveyances
 - In doing so, the court of appeals ducked the issue of whether indirect benefits could constitute “reasonably equivalent value”. It did not say that indirect benefits could never constitute “reasonably equivalent value”, but rather that the indirect benefits in that case “were not close to being reasonably equivalent value to the \$403 million of obligations they incurred”
 - The court of appeals did not address the Bankruptcy Court’s ruling with respect to the enforceability of the savings clauses in the guarantees

Reasonably Equivalent Value/ Fair Consideration

- **The circuit court largely ignored those cases holding that intangible and unquantifiable benefits can constitute value under the Bankruptcy Code.**
 - *See, e.g., Mellon Bank, N.A. v. Metro Commc'ns, Inc.*, 945 F.2d 635, 647 (3d Cir. 1991) (intangible benefits, although incapable of precise measurement can confer value);
 - *Leibowitz v. Parkway Bank & Trust Co. (In re Image Worldwide, Ltd.)*, 139 F.3d 574 (7th Cir. 1998) (indirect benefits to guarantor may be considered)

Reasonably Equivalent Value/ Fair Consideration

- ***TOUSA***
 - “Savings clause” issue
 - Purpose of these clauses is to automatically adjust a borrower's or guarantor's liability to the largest amount that would leave the borrower or guarantor solvent.

Reasonably Equivalent Value/ Fair Consideration

- ***TOUSA***

- Bankruptcy court ruled that the “savings clause” could not be used to contract around Bankruptcy Code.

- “[T]he savings clauses, if given the effect claimed by Defendants, would defeat the debtors’ cause of action for a fraudulent transfer, and a cause of action is unquestionably property of the debtor.” *In re TOUSA, Inc.*, 422 B.R. 783, 864 (Bankr. S.D. Fla. 2009)
 - “The savings clauses are unenforceable for the ... reason that efforts to contract around the core provisions of the Bankruptcy Code are invalid.” *Id.* at 864-65.

Reasonably Equivalent Value/ Fair Consideration

- **TOUSA**

- "As a matter of contract law, the necessary conclusion is that the savings clauses are unenforceable. If the terms of the agreement are so vague and indefinite that there is no basis or standard for deciding whether the agreement had been kept or broken, or to fashion a remedy, and no means by which such terms may be made certain, then there is no enforceable contract." *Id.* at 865.

Reasonably Equivalent Value/ Fair Consideration

- **Specifying use of proceeds**

- Knowledge issues

- Impact on avoidance

- *In re TOUSA, Inc.*, 680 F.3d 1298, 1313 (11th Cir. 2012) ("The bankruptcy court correctly asked, 'based on the circumstances that existed at the time the investment was contemplated, whether there was any chance that the investment would generate a positive return'.... And the record supports the negative answer found by the bankruptcy court.")

Insolvent or Rendered Insolvent

- **Code § 548(a)(1): “The trustee may avoid any transfer ... if the debtor ... received less than 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, or became insolvent as a result of such transfer or obligation ...*”**

Insolvent or Rendered Insolvent

- **How insolvency is determined**

- Balance sheet insolvency (Bankruptcy Code §101(32)):
“financial condition such that the sum of such entity’s debts is greater than all of such entity’s property, at a fair valuation....”
 - Not just looking at balance sheet and making adjustments
 - See, e.g., *In re Yellowstone Mtn. Club, LLC*, 436 B.R. 598, 659 (Bankr. D. Mont. 2010) ("neither 'book value' nor 'generally accepted accounting principles' control a court's decision on projections or value").

Insolvent or Rendered Insolvent

- **How insolvency is determined**

- Courts look at valuation based upon the discounted cash flow approach, the comparable company approach and a comparable transaction analysis, as well as using the adjusted balance sheet
 - See, e.g., *In re Tronox Inc.*, 503 B.R. 239, 316- (Bankr. S.D.N.Y. 2013) (considering expert testimony on enterprise value applying a discounted flow analysis, comparable company analysis and a comparable transaction analysis);
 - *In re Enron Corp.*, 2005 WL 6237551 (Bankr. S.D. Tex. Dec. 9, 2005) (finding to be credible an expert's report on insolvency based on discounted cash flow valuation);
 - *In re Joshua Slocum, Ltd.*, 103 B.R. 610 (Bankr. E.D. Pa. 1989) (examining adjusted balance sheet analysis to determine insolvency).
- Treatment of contingent liabilities
 - In determining solvency the bankruptcy court will look at contingent liabilities and value them based upon the probability that the debtor will become responsible for payment, and the likely amount.

Unreasonably Small Capital

- **Code § 548(a)(1):** “The trustee may avoid any transfer ... if the debtor ... received less than reasonably equivalent value in exchange for such transfer or obligation; and ... *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 ...*”
- **Bankruptcy Code** provides no guidance on what constitutes “unreasonably small capital”

Unreasonably Small Capital

- **Test is typically applied where a transaction leaves a debtor technically solvent, but essentially, destined to fail**
 - *See In re Tronox Inc.*, 503 B.R. 239, 321 (Bankr. S.D.N.Y. 2013) ("unreasonably small capital' means' difficulties which are short of insolvency in any sense but are likely to lead to insolvency at some time in the future");
 - *ASARCO LLC v. Am. Mining Corp.* , 396 B.R. 278, 396 (S.D. Tex. 2008) ("The test is aimed at transferees that leave the transferor technically solvent but doomed to fail.").

Unreasonably Small Capital

- **Inadequate capital is based on a prospective analysis regarding the debtor's future business and operations, whereas insolvency is more of a snapshot of financial condition at a particular moment in time**

Unreasonably Small Capital

- **Looks beyond the date of the transfer, to assess impact of transfer on a debtor's ability to conduct its affairs**
- **Courts look to factors such as:**
 - Debtor's debt to equity ratio
 - Historical capital cushion
 - Debtor's projected cash flow (including the reasonableness of the assumptions underlying the projections in light of historical operating performance, macro economic indicators, the cyclical nature of the industry and the need for margin of error)
 - Need for working capital in the industry at large
 - See, e.g., *In re Iridium Operating LLC*, 373 B.R. 283, 345 (Bankr. S.D.N.Y.); *MFS/Sun Life Trust- High Yield Series v. Van Dusen Airport Svcs. Co.*, 910 F. Supp. 913, 944-45 (S.D.N.Y. 1995); *Credit Managers Ass'n of So. Cal. v. Fed. Co.*, 629 F. Supp 175, 183-88 (C.D. Cal. 1985).

Unreasonably Small Capital

- **Reasonably foreseeable that company would have unreasonably small capital after transaction? See *Moody v. Sec. Pac. Bus. Credit, Inc.*, 971 F.2d 1056 (3d Cir. 1992)**

Inability to Pay Debts as They Become Due

- **Code § 548(a)(1):** “The trustee may avoid any transfer ... if the debtor ... received less than reasonably equivalent value in exchange for such transfer or obligation; and ... *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...*”
- **Intent can be inferred where the facts and circumstances of transaction show that debtor could not have reasonably believed it would be able to pay the debts as they matured**
 - See *In re Doctors Hosp. of Hyde Park, Inc.*, 2013 WL 5524696, *70 (Bankr. N.D. Ill. Oct. 4, 2013).
- **Analysis is similar to test for unreasonably small capital**

Defenses

- **Statute of limitations**
- **Good faith defense (Bankruptcy Code § 548(c))**
 - Transferee must show both value and good faith
 - Good faith not defined by the Bankruptcy Code
 - Knowledge of transferee -- did transferee know that debtor was insolvent, or that transfer may have been made or obligation incurred with fraudulent purpose?
 - Would a diligent investigation have revealed such facts?
 - "[E]very creditor must exercise some diligence when receiving payment from a struggling debtor. It is far from a drastic obligation to expect some diligence from a creditor when it is being repaid hundreds of millions of dollars by someone other than its debtor." *In re TOUSA, Inc.*, 680 F.3d 1298, 1315 (11th Cir. 2012).

Defenses

- **Good faith for subsequent transferees (*i.e.*, not the initial transferee) (Bankruptcy Code § 550(b))**
 - Subsequent transferee protected from avoidance if he takes for value, in good faith, and without knowledge of the voidability of the transfers.
- **Ratification**
 - Parties who have ratified an alleged fraudulent transfer cannot seek to have that transfer avoided.
 - See, e.g., *In re Lyondell Chem. Co.*, 503 B.R. 348, 383-85 (Bankr. S.D.N.Y. 2014) (dismissing fraudulent conveyance claims brought against shareholders by creditor trust, on behalf of LBO lenders because LBO lenders were participants in transaction and could not seek to have transfer avoided);
 - *In re Tronox, Inc.*, 503 B.R. 239, 276 (Bankr. S.D.N.Y. 2013) (rejecting ratification defense; plaintiffs did not knowingly ratify to the conveyances).

Defenses

- **Safe Harbor Defense – Bankruptcy Code § 546(e)**
 - "Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548 (b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this time."

Defenses

- **Safe Harbor Defense – Bankruptcy Code § 546(e)**
 - Provides a safe-harbor defense for payments made in connection with, among other things, securities contracts.
 - Designed to reduce systemic risk to the markets and protect market integrity.
 - Reflects Congressional intent that when securities markets are involved, it is better not to disturb certain prepetition transfers than to collect assets for equitable distribution to creditors.
 - Ironically, protects selling shareholders in LBO transactions but not lenders.

Defenses

- **Safe Harbor Defense – Bankruptcy Code § 546(e)**
 - Courts to date have given expansive application of the defense to, among other things, payments made on account of commercial paper and the sale of securities in private companies
 - See *In re Enron Creditors Recovery Corp.*, 651 F.3d 329 (2d Cir. 2011) (debtor's payments to investors for early redemption of commercial paper were protected by section 546(e); redemption payments completed transaction in securities, although they involved retirement of debt);
 - *In re Quebecor World (USA) Inc.*, 719 F.3d 94 (2d Cir. 2012) (payment to allow debtors to repurchase and cancel privately-placed notes protected by section 546(e)).
 - *In re Derivium Capital LLC*, 716 F.3d 355 (4th Cir. 2013) (commission payments to stockbroker shielded; no exception even in context of Ponzi scheme)
 - But see *In re MacNenamin's Grill, Ltd.*, 450 B.R. 414, 419-27 (Bankr. S.D.N.Y. 2011) (section 546(e) did not apply to private stock transaction).

Defenses

- **Safe Harbor Defense -- Code § 546(e)**
 - Likely does not bar state law fraudulent conveyance claims brought by or on behalf of individual creditors
 - *See, e.g., In re Lyondell Chem. Co.*, 503 B.R. 348 (Bankr. S.D.N.Y. 2014) (section 546(e) does not act to bar state law claims);
 - *In re Tribune Co. Fraudulent Conveyance Litig.*, 499 B.R. 310 (S.D.N.Y. 2013) (same).
 - *But see Whyte v. Barclays Bank PLC*, 49 B.R. 196 (S.D.N.Y. 2013) (section 546(e) barred state law claims when claims were brought by creditor trust as “trustee” *and* on behalf of creditors).

Defenses

- **Safe Harbor Defense -- Code § 546(e)**
 - No decision has yet addressed whether payments made on account of loans made under a loan agreement are protected by Bankruptcy Code § 546(e).
 - Does not apply if transfer was made or obligation was incurred with actual intent to hinder, delay, or defraud creditors.

Damages/Liability

- **If a transfer is avoided under § 548, trustee may recover either:**
 - the property transferred or
 - the value of the property
- **Bankruptcy Code § 550: “[T]he 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; or
 - (2) any immediate or mediate transferee of such initial transferee.”

Damages/Liability

- **“Entity for whose benefit such transfer was made” can be a very broad category. Parent or affiliated companies, or guarantors, even if they were not the transferee**
 - Recent decision held that a second lien lender was a party “for whose benefit a transfer was made” where debtors made a payment to the first lien lender that resulted in an improvement in the second lien lender's collateral position. *In re Vassau*, 484 B.R. 864 (Bankr. S.D. Cal. 2013).
- **Subsequent transferees may also be at risk of avoidance (subject to good faith defense)**

Damages/Liability

- ***In re Tronox, Inc.*, 503 B.R. 239 (Bankr. S.D.N.Y. 2013)**
 - Spin-off of business constituted fraudulent transfer intended to shield company from massive environmental liabilities.
 - Avoided transfers that began 7 years before bankruptcy filing because transfers were part of “single integrated scheme” culminating within the 4-year reach-back period.
 - Awarded damages far in excess of unpaid creditor claims. Court concluded that under confirmed plan creditors exchanged right to payment for a share of the damages (if any) awarded in the lawsuit

Lender Diligence Requirements

- **In the wake of TOUSA, lenders have considerably heightened diligence obligations to preserve a good faith defense**
- **Lenders should also consider preservation of diligence materials for at least six years**

Lender Diligence Requirements

- **When making loans, lenders should evaluate**
 - Solvency opinions and adequate capital analysis, for each borrower and guarantor on a stand-alone basis, and on a consolidated basis
 - Assure fee structures are appropriate and not designed to encourage a particular conclusion
 - Valuation analyses
 - Business forecasts
 - Test reasonableness of assumptions
 - Prepare “downside” case
 - Benefits/indirect benefits to be received by each borrower and guarantor
 - Have borrower and guarantor identify and articulate these benefits in writing

Lender Diligence Requirements

- **When receiving repayment of loans, lenders should evaluate**
 - Source of funds
 - Deal structure
 - Fraudulent conveyance analyses to determine if reserve needed

Drafting Considerations

- **In addition to diligence, lenders can get additional protection from:**
 - Representations and warranties (no insolvency; use of proceeds, etc.)
 - Board resolutions stating benefits to be realized from proposed transaction
 - A “net worth guarantee” (instead of a savings clause) that caps a guaranty in an amount not greater than a percentage of the guarantor's net worth
 - A contribution agreement among guarantors that allocates the liability among them based on the benefits each received in the transaction

Intercreditor Issues

- **If a fraudulent conveyance claim is successfully prosecuted against one or more lenders under a credit facility, who bears the burden of the judgment (which may result in avoidance of liens, disallowance of claims, equitable subordination and/or monetary damages)?**
 - Equal and ratable sharing provisions
 - One “bad actor” versus the syndicate
 - Unitranche transactions
 - Combines separate facilities into single set of documents between originating lender and borrower
 - Originating lender enters into “agreement among lenders” carving up “tranches” for other investors
 - Largely untested in bankruptcy courts
 - Revolving credit lenders versus term lenders
 - Intercreditor agreements

Q & A

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