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FRAUDULENT CONVEYANCES IN THE CONTEXT OF LBO's

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In 1571, Parliament enacted the statute of 13 Elizabeth. The Statute imposed criminal penalties and voided transfers of property that "are devised and contrived of malice, fraud, coven, collusion, or guile, to the end purpose and intent, to delay, hinder, or defraud creditors and offers of their just and lawful actions..." Predictably, intent was inordinately difficult to prove. Courts began to enunciate "badges of fraud" - fact patterns that would give rise to presumptions of intent to defraud and allow the courts to treat a transaction as a fraudulent conveyance even though actual intent to defraud did not exist or could not be proved. Dozens of "badges" were developed in the succeeding centuries, which when combined with inconsistent interpretations, resulted in considerable confusion.

The Uniform Fraudulent Conveyance Act (UFCA), first promulgated in 1918, was drafted to eliminate the confusion and inconsistency by requiring proof of actual fraud without the benefit of presumptions while retaining certain of the "badges" that were capable of objective proof making them irrebutable presumptions of fraud. It was intended that there be a distinction between actual fraud, which requires intent, and constructive fraud, which results in voidable transactions regardless of intent.

Not all states have adopted the UFCA; thus, to the extent it is relevant, the nonconforming law of a number of states must be consulted. Furthermore, to complicate matters, Congress adopted a slightly different version of the UFCA for incorporation into the Bankruptcy Act of 1898.[1]

The UFCA and the Federal Bankruptcy Act version of the UFCA, in slightly different language, continue to render voidable "every conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay or defraud

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[1] Bankruptcy Act sec. 67d (1898), as amended, 11 U.S.C. sec. 107(4) (1970).

either present or future creditors." With regard to conveyances and obligations made not with actual intent, but with intent presumed in law, the UFCA and the Bankruptcy Act[2], again in slightly different language, state that:

> "Every conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation is incurred without fair consideration."

Granting a security interest in assets to collateralize a loan or a guaranty is unquestionably a "conveyance" within the meaning of the statutory provisions. Taking out a loan or giving a guaranty are "obligations" incurred. A literal reading of the statute requires receipt of a balance sheet asset or cancellation of a balance sheet liability to qualify as fair consideration.

Generically, an upstream guaranty is defined as a transfer of benefits from the subsidiary to its shareholder(s) for which the subsidiary receives no reasonable equivalent value in return. Such guaranties could withstand attack only to the extent that the guarantor was unquestionably solvent at the point in time that the obligation of guaranty was incurred and that no reasonably informed person would anticipate insolvency subsequent to and resulting from the obligation of guaranty.

Thus, under the Statute, absent proof of actual intent to delay, hinder or defraud creditors, a transfer by an insolvent company for fair consideration is valid. Also, a transfer without fair consideration by a solvent company is unchallengeable. Lack of fair consideration combined with insolvency gives rise to an irrebuttable presumption of an intent to defraud creditors.

In the corporate context, fraudulent conveyance actions most frequently arise out of leveraged buy-outs (LBOs) of companies which are or become insolvent. An LBO refers to the acquisition of a company for cash, a significant portion of which is borrowed and secured by the target's assets. Companies with underemployed assets that lack management or financial

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[2] Sec. 67d (2) (a), 11 U.S.C. sec. 568 (1982).

resources to improve utilization and thereby improve earnings are frequent candidates for an LBO. Because sound financial condition is not a prerequisite to a buy-out, LBOs frequently result in highly leveraged companies which have minimum margins for error.

A common characteristic of LBOs is that the selling shareholders receive cash for their shares from the proceeds of the LBO loan. Therefore, the target company, whose assets have been pledged to secure repayment of the loan, does not beneficially receive the loan proceeds. Thus, ostensibly lacking "fair consideration" for the conveyance made and/or the obligation incurred, if the target is contemporaneously insolvent or is rendered insolvent thereby, and should bankruptcy intervene, a present creditor of the target remain unpaid, the general creditors may challenge the lender's security interests, mortgages and guaranties as fraudulent conveyances. Under some state law, the bankruptcy trustee would have the power to assert fraudulent conveyance rights on behalf of the general creditors.

Under 11 U.S.C. see. 548(a), the trustee could make two distinct prima facie cases for fraudulent conveyance. First, the trustee could prove that the LBO is an intentional fraud on creditors. Second, under 11 U.S.C. sec. 548(a) (2), the trustee could prove that the target company did not receive a reasonably equivalent value in exchange for creating rights in the LBO.

The second prima facie case must be supplemented with further proof that the target company:

> (i) was insolvent ... or became insolvent as a result of such transfer or obligations;
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> (ii) was engaged in business ... for which any property remaining was unreasonably small capital; or,
>
> (iii) intended to incur ... debts that would be beyond the debtor's ability to pay as such debts matured.

The lender who acts in good faith should have a defense against fraudulent conveyance attacks under Section 548(c), which states in part:

> "(the lender) ... that takes for value and in good faith ... may retain any lien transferred, or may enforce any obligation incurred ..."

The basis of the lender's "good faith" defense is that it reasonably believed 1) if presently solvent, the target company would not be rendered insolvent by the loan; or 2) if insolvent at the time of the transaction, the target company would emerge as a solvent company and "be enabled to promote the interest of all other creditors by continuing his business."[3]

Although "good faith" is not defined in the Bankruptcy Code, one can presume that a lender acts in good faith where it is not actually aware of circumstances suggesting fraud and where it investigated the target company with the diligence expected from the reasonably prudent lender. In Chorost v. Grand Rapids Factory Showrooms, the court stated:[4]

> "A man cannot successfully claim that he is acting honestly when he willfully shuts his eyes for fear that leaving them open will reveal unpleasant facts."

At the very least, diligence would be defined as a review by the lender of the company's credit and an analysis of the impact on the company of the proposed loan. In today's litigious environment, the prudent lender would seek the opinion of an independent expert. An expert's opinion as to solvency, alone, will, not suffice. Pursuant to section 548(a)(2), the independent expert must submit a three-part opinion as to:

- Solvency;
- Capital adequacy; and,
- Fixed charge coverage.

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[3] Dean v. Davis 242 U.S. 444 (1971).

[4] 77 F. supp. 276, 281 (D.N.J. 1948), aff'd, 172 F. 2d 327, 329 (3rd Cir.1949).