Commercial Law & Bankruptcy Section

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FRAUDULENT TRANSFERS

A summary of bankruptcy and state law claims

I. INTRODUCTION

A bankruptcy trustee has the ability and authority to pursue fraudulent conveyances both under federal bankruptcy law and pursuant to Idaho State law. Federal bankruptcy law imposes a two year statute of limitation prior to the filing of a bankruptcy petition and Idaho State law provides for a four year statute of limitation after the transfer occurred or within one year after it could have reasonably been discovered. There is also a special one year statute of limitation relating to transfers to insiders that requires a lesser burden of proof. *See,* Idaho Code §55-914(2) and §55-918.

An important distinction between federal bankruptcy law and Idaho law is that pursuant to Idaho law there must be a creditor of the debtor and reference to such creditor should be referenced in the complaint. To the contrary, pursuant to bankruptcy law, a bankruptcy trustee is a hypothetical lien creditor and there is no requirement to establish any other creditors existed.

Set forth below is a summary and brief analysis of the various elements that must be proven pursuant to federal bankruptcy statutes and Idaho state statutes relating to fraudulent transfers.

II. SECTION 544

"Under Section 544(a)(1), as of the commencement of the case, the trustee is given the status of a hypothetical lien creditor." *The Law of Debtors and Creditors* § 16:5 (2008). The trustee status is hypothetical because "it is not in any way dependent on the existence of any actual creditor who did or could have obtained the status of a judicial lien or execution creditor as of the time in question." *Commercial Bankruptcy Litigation* § 10:2 (2008).

> In other words, the trustee may avoid and recover for the estate all property of the debtor and all transfers and encumbrances, including creation of security interests that as of the commencement of the case could have been reached or avoided by a judicial lien creditor. The theory behind this section is that property that could have been reached by and that was available to lien creditors at the time the petition was filed should be available to the debtor's estate for distribution to the creditors.

The Law of Debtors and Creditors § 16:5 (2008).

"Section 544(a) also makes it clear that the trustee's status as a hypothetical lien creditor exists whether or not such a creditor exists." *Id.* (overruling decision from Ninth Circuit Court of Appeals holding that hypothetical creditor status only created if a creditor existed who could have avoided the transaction.). The trustee's "status is generated by force of the Code, and is not dependent on the existence of an actual creditor who could have or did obtain a lien via judicial procedures. Prior case law suggesting such a limitation is expressly overruled." 4 *Norton Bankr. L. & Prac.* 3rd § 63:5 (2009).

> Under Code § 544(a)(1), the trustee is treated as if he or she extended credit at the time the petition was filed, obtained a judgment at that time, and levied on all of the property of the debtor that could be reached by an execution creditor under applicable state law. In other words, the trustee may avoid and recover for the estate all property of the debtor and all transfers and encumbrances, including creation of security interests, that as of the commencement of the case could have been reached or avoided by a judicial lien creditor.

Id.

> Section 544 confers upon the bankruptcy trustee the status of an ideal creditor armed with every right and power which is conferred by state law

> upon its most favored creditor who has acquired a lien by legal or equitable proceeding. 4 Collier, *supra* at 544-4. The trustee's powers are those which the nonbankruptcy law would allow to a hypothetical creditor of the debtor. Section 544 does not confer on the trustee any greater rights than those accorded by nonbankruptcy law to such a creditor. *Heffron v. Duggins*, 115 F.2d 519 (9th Cir. 1940). Thus, if a creditor is deemed barred from recovery because of the running of a statute of limitations prior to the commencement of the case, the trustee is likewise rendered impotent. The leading case cited by 4 Collier, *supra* at 544-20 is *Davis v. Willey*, 263 F. 588 (D.Cal.1920) *aff'd*, 273 F. 397 (9th Cir. 1921), where the Court declared that "if, for any reason arising under the laws of the state the action could not be maintained by the creditor, the same disability will bar the trustee."

In re Golden H. Packing Co., 11 B.R. 111, 114 (Bankr. Nev. 1981).

III. SECTION 548 (Actual Fraud and Constructive Fraud)

Section 548 of the Bankruptcy Code provides a framework in which to analyze whether a transfer was a fraudulent transfer. Section 548 states in pertinent part:

> The trustee may avoid any transfer (including the transfer to or for the benefit of an insider under an employment contract) of an **interest of the debtor in property** . . . that was made or incurred on or within **2 years** before the date of the filing of the petition, if the debtor voluntary or involuntarily -
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> (A) made such transfer or incurred such obligation with actual **intent to hinder, delay, or defraud** any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; **or**
>
> (B)
>
> (i) received less than a **reasonably equivalent value** in exchange for such transfer or obligation; **and**
>
> (ii)
>
> (I) **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;
>
> (II) 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**;
>
> (III) 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**
>
> (IV) 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.

11 U.S.C. § 548(a)(1) (emphasis added).

1. (<u>Actual Fraud) - Bankruptcy Code § 548(a)(1)(A) and I.C. § 55-913</u>.

"A transfer is actually fraudulent when a debtor makes a transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became . . . indebted." 11 U.S.C. § 548(a)(1(A); *In re Roca*, 404 B.R. 531, 543 (Bankr. D. Ariz. 2009). A debtor's intent under § 548(a)(1)(A) is established by circumstantial evidence. *Id.*; *Crawforth v. Bachman,* 2007 WL 4355620 (Bankr. D. Idaho 2007). When evaluating whether actual intent was present, the court will consider circumstances commonly associated with fraudulent transfers, referred to as "badges of fraud." *In re Roca*, 404 B.R. at 543. Common badges of fraud include, but are not limited to:

(1) the transfer 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 or obligation was made or obligation was incurred, the debtor was sued or threatened with suit;
(5) the transfer was of substantially all of 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 [not] 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 had transferred the essential assets of the business to a lienor who had transferred the assets to an insider of the debtor.

In re Roca, 404 B.R. at 544; *In re Lull,* 386 B.R. 261, 271 (Bankr. D. Hawaii 2008). In addition, the court in *Roca* stated that while state law is not used to avoid a transfer pursuant to § 548, a court may review state law as to certain nonexclusive factors that a court may rely on in determining whether actual intent exists. *Id.* Idaho Code § 55-913 provides a list of factors that may be considered in determining whether actual intent existed to establish a fraudulent transfer.

(a) The transfer or obligation was to an insider;
(b) The debtor retained possession or control of the property transferred after the transfer;
(c) The transfer or obligation was disclosed or concealed;
(d) Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
(e) The transfer was of substantially all the debtor's assets;
(f) The debtor abscounded [absconded];
(g) The debtor removed or concealed assets;
(h) 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;
(i) The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
(j) The transfer occurred shortly before or shortly after a substantial debt was incurred; and
(k) The debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

I.C. § 55-913. A trustee is only required to "show the presence of the intent to hinder, or the intent to delay, or the intent to defraud; it is not necessary for the trustee to show the presence of all three types of intent in order to avoid the transfer." *In re Roca*, 404 B.R. at 544.

2. <u>(Constructive Fraud) – Bankruptcy Code 548(a)(1)(B)</u>

The second method for establishing a fraudulent transfer pursuant § 548 is contained in § 548(a)(1)(B), which related to constructive fraud. "In essence, <u>section 548(a)(1)(B)</u> is just the converse of <u>section 548(a)(1)(A)</u> inasmuch as proof of less than full value received is essential under <u>section 548(a)(1)(B)</u>, but proof of actual intent to prejudice creditors is not." *Commercial Bankruptcy Litigation* § 10:30 (2008).

> <u>Section 548(a)(1)(B)</u> allows a trustee to avoid any transfer where the debtors "received less than a reasonably equivalent value in exchange for such transfer or obligation," and the trustee can satisfy one of four alternative grounds: (1) the debtor was insolvent or became insolvent as a result of the transfer; (2) the debtor was left insufficiently capitalized following the transfer; (3) the transferor intended to incur, or believed it would incur, debts beyond the debtor's ability to pay as such debts matured, or (4) the transfer was made to an insider, or the debtor incurred an obligation for the benefit of an insider under an employment contract and not in the ordinary course of business.

Commercial Bankruptcy Litigation § 11:33 (2008).[1]

(a) Reasonably Equivalent Value.

"To the extent that the debtor receives less than fair value for the property transferred or obligation incurred, and provided that the other conditions of section 548(a)(1)(B)(ii)(I), (II), (III), or (IV) can be established, fraud is conclusively presumed." *Commercial Bankruptcy Litigation* § 11:33 (2008).

> What is "reasonably equivalent value" is not defined by the legislature. That function has been left to the courts. *McCanna v. Burke,* 197 B.R. 333, 338-39 (D.N.M.1996). There is no hard and fast rule in the Ninth Circuit as to what constitutes "reasonably equivalent value." The concept of "reasonable equivalence" is not wholly synonymous with "market value" even though market value is an extremely important factor to be used in the court's analysis. *In re Morris Communications NC, Inc.,* 914 F.2d 458, 466 (4th Cir.1990). The transferee's "good faith" is also a relevant factor. *In re Smith,* 24 B.R. 19, 23 (Bankr.W.D.N.C.1982).
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> Whether the transfer is for "reasonably equivalent value" in every case is largely a question of fact, to which considerable latitude must be given to the trier of fact. *In re Ozark Restaurant Equip. Co.,* 850 F.2d 342, 344 (8th Cir.1988). In order to determine whether a fair economic exchange has occurred, the court must analyze all the circumstances surrounding the transfer in question.

In re Kemmer, 265 B.R. 224 (E.D. Cal. 2001).

When the debtor receives nothing in exchange for the transfer, the requirement of "less than reasonably equivalent value" is fulfilled. *In re Trujillo,* 215 B.R. 200 (9th Cir. 1997). "Whether a debtor received a reasonably equivalent value is analyzed from the point of view of the debtor's creditors, because the function of this element is to allow avoidance of only those transfers that result in a diminution of a debtor's prepetition assets." *In re Jordan,* 392 B.R. 428, 441-42 (Bankr. D. Idaho 2008). In addition, "[t]he determination of reasonable equivalence must be made as of the time of the transfer." *Id.*

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[1] The elements analyzed under § 548 are equally applicable to a fraudulent transfer pursuant to Idaho law.

Once a trustee has proven that no equivalent value was received for the transfer, the Trustee can prove any one of the four element identified in § 548(a)(1)(B)(ii) to prevail on its claim that a fraudulent transfer occurred.

IV. IDAHO STATE FRAUDULENT CONVEYANCE LAW

1. Idaho Code § 55-913 provides that:

(1) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose **before or after** the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:

(a) With **actual intent** to hinder, delay, or defraud any creditor of the debtor; **or**

(b) Without receiving a **reasonably equivalent value** in exchange for the transfer or obligation, and the debtor:

1. was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
2. intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due.

(2) In determining actual intent under subsection (1)(a) of this section, consideration may be given, among other factors, as to whether:

(a) The transfer or obligation was to an **insider**;
(b) The debtor retained possession or control of the property transferred after the transfer;
(c) The transfer or obligation was disclosed or concealed;
(d) Before the transfer was made or obligation was incurred, the debtor had been sued or **threatened with suit**;
(e) The transfer was of **substantially all the debtor's assets**;
(f) The debtor abscounded [absconded];
(g) The debtor removed or concealed assets;
(h) 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;
(i) The debtor was **insolvent or became insolvent** shortly after the transfer was made or the obligation was incurred;
(j) The transfer occurred shortly before or shortly after a substantial debt was incurred; and
(k) The debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

I.C. § 55-913 (emphasis added). It is important to note that the definition of "insolvency" under state law may encompass both a balance sheet or income statement approach, *see* I.C. §55-911, but under federal bankruptcy law only a balance sheet approach is included, *see* 11 U.S.C. §101(32); however, the income statement approach may be considered a "badge" of actual fraud in relation to §548(a)(1)(A).