What Are Fraudulent Transfer Claims and What Defenses Exist to Such Claims?

A fraudulent transfer is a wrongful attempt to avoid a debt by improperly transferring assets to a third party, or transferring assets for less than fair value while insolvent or leading to insolvency. Though each state has its own statute regarding fraudulent transfers, which may be identical or similar to the Uniform Voidable Transactions Act (UVTA) or its predecessor, the Uniform Fraudulent Transfer Act (UFTA), Section 548 of the Bankruptcy Code gives a trustee additional statutory authority to seek to avoid or unwind a fraudulent transfer when the debtor is in bankruptcy. This framework is designed to prevent a debtor from thwarting its creditors' rights by improperly transferring its assets. If no bankruptcy has been filed, a creditor may seek to avoid a fraudulent transfer under state law as part of its own collection efforts. In bankruptcy, creditors themselves can no longer pursue fraudulent transfer claims, but a trustee or debtor-in-possession may seek to avoid a fraudulent transfer for the benefit of all creditors.

Key Issues

- **What is A Transfer for Purposes of a Fraudulent Transfer Claim?** Section 548 of the Bankruptcy Code governs fraudulent "transfers." What constitutes a "transfer" is not as straightforward as one might think. The stereotypical transaction — a debtor gives cash to a third party — likely constitutes a transfer. However, other conduct may constitute a transfer. For example, under the Bankruptcy Code, a transfer may also mean (i) the creation of a lien, (ii) the retention of title as a security interest, and (iii) the foreclosure of a debtor's equity of redemption. Furthermore, a transaction may constitute a transfer for purposes of Section 548 of the Bankruptcy Code even if the debtor did not make the transfer — a third party may transfer a debtor's *interest in property* and trigger a fraudulent transfer action.
- **What are the Types of Fraudulent Transfer Claims?** The Bankruptcy Code identifies two types of fraudulent transfers, actual fraud and constructive fraud, that can be avoided or unwound. A creditor or trustee may pursue either type of fraudulent transfer, or both types alternatively.

A transfer constitutes actual fraud when the transferor knowingly and intentionally transfers assets to a third party to "hinder, delay, or defraud a creditor." With actual fraud, deciphering the debtor's intent is of paramount concern and is often difficult to prove. Though no bright line rule exists in determining actual fraud (and intent), bankruptcy courts often refer to UFTA, which identifies certain "badges" or indicators of actual fraud. These indicators include, but are not limited to, (i) whether the transfer was to an insider, (ii) whether the debtor remained in control of the property after the transfer, (iii) whether the debtor absconded or concealed assets, and (iv) whether the transfer occurred shortly before or after a substantial debt was incurred.

A transfer constitutes constructive fraud if the debtor received less than "reasonably equivalent value" for the transfer *and* either (i) the debtor was insolvent when the transfer was made or was rendered insolvent as a result of such transfer, (ii) the debtor had unreasonably small capital, (iii) the debtor intended to incur debts beyond its ability to repay them, or (iv) the transfer benefited an insider under an employment contract and not in the ordinary course of business. Determining whether a transferee received "less than reasonably equivalent value" is easy when nothing was provided in exchange for the transfer. However, more often than not, some value is given, making it difficult to determine whether the value provided was really adequate. This determination is fact intensive, often requiring an expert, and courts may consider whether the transfer was made for fair market value or in good faith. If the transfer was made to solely benefit a third party, reasonably equivalent value may not have been given. Additionally, the solvency of the debtor at the time of the transfer is often a hotly contested issue. The solvency of the debtor is fact intensive and often requires an expert.

- **What is the Deadline to Assert a Fraudulent Transfer Claim?** A fraudulent transfer action under the Bankruptcy Code generally must be commenced by the later of (i) two years after the bankruptcy was filed or (ii) one year after the appointment of a trustee in a bankruptcy case (so long as the appointment occurred within two years of the commencement of the bankruptcy). A bankruptcy court may extend this filing deadline. Also, it is important to note that states' fraudulent transfer laws, like UFTA, may provide for longer statutes of limitations that a trustee may utilize in the bankruptcy.
- **What Happens to a Fraudulent Transfer Claim?** The repercussions for actual and constructive fraud are the same. If a transfer is voided or unwound as a fraudulent transfer, the property may be recovered and distributed to a debtor's creditors pursuant to bankruptcy law. Alternatively, the court may also enter a judgment against the transferee equal to the value of the asset transferred.
- **What are the Defenses to a Fraudulent Transfer Claim?** A transferee may assert one or more defenses to a fraudulent transfer action to retain the property or assets it receives from a debtor. In the first instance, transferees often dispute that the elements under Section 548 of the Bankruptcy Code have been met. This means a transferee, if possible and applicable, disputes (i) whether there existed any "badges" or indicators of actual fraud or (ii) whether the debtor received less than reasonably equivalent value for the transfer or whether the debtor was insolvent when the transfer was made or was rendered insolvent as a result of such transfer. Other common defenses include (i) the safe harbor under Section 546(e) of the Bankruptcy Code and (ii) the good faith defense, which are both described at a high level below:

- Safe Harbor. If the transfer was made by, to, or for the benefit of certain financial entities, such as a commodity broker, contract merchant, financial institution, financial participant, or securities clearing agent, a transferee may be able to protect the transfer from being avoided under Section 546 of the Bankruptcy Code.
- Good Faith. A transferee who receives a debtor's transfer in good faith and provides value may be able to assert the good-faith defense under Section 550(b) of the Bankruptcy Code. This defense is designed to protect a transferee who had no knowledge that the transfer was voidable.

Takeaway

Fraudulent transfers can be a significant source of litigation and recovery for a creditor pursuing its own collection efforts when a debtor is not in bankruptcy, and for creditors generally when the debtor is in bankruptcy. There are many nuances to fraudulent transfers (both actions and defenses) that require an in-depth analysis and review. Creditors attempting to avoid or unwind a fraudulent transfer, and transferees seeking to retain possession of an alleged fraudulent transfer, should retain competent legal counsel to ensure their rights are protected.