Professional Perspective

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Fraudulent transfer litigation is a valuable weapon in the bankruptcy code arsenal that is commonly used to target assets that were transferred or otherwise disposed of prior to the bankruptcy. These assets, if successfully recovered, have the potential to provide greater recovery, or at least some recovery, to creditors of the debtor's estate.

The last two years saw an uptick in the use of Chapter 11 purely to reorganize rather than to simply liquidate a debtor and its affiliates, which are commonly included as co-debtors. Additionally, Chapter 11 bankruptcy cases are being confirmed in records speeds. These corporate restructurings may be used to shed unprofitable business sectors, shift assets and liabilities among debtor entities and their non-debtor affiliates, and alter the rights of creditors in the blink of an eye.

Now more than ever, it is critical for creditors to diligently and efficiently investigate the debtors' transfers, specifically amongst the reorganizing debtors and their non-debtor affiliates. This investigation may be the key to creditor recoveries, and it is crucial that causes of action relating to transfers be maintained and pursued.

Causes of action for fraudulent transfer, commonly referred to in bankruptcy as "avoidance actions," may be brought by a debtor-in-possession, a Chapter 7 or Chapter 11 bankruptcy trustee, or any other party in interest upon whom the court affirmatively confers standing to bring such action, such as an official committee. Additionally, through a plan of reorganization or liquidation, debtors commonly assign the right to bring avoidance actions to a post-confirmation fiduciary, such as a plan administrator or liquidating trustee, and such assignment is often approved by the bankruptcy court through the confirmation order.

Assets can slip away from the bankruptcy estate and the grip of creditors in countless ways, both innocently and through fraudulent intent. Aside from "traditional" fraudulent transfer fact patterns, loan forgiveness or debt cancellation can each potentially be the basis for fraudulent transfer claims, but such claims are seldom pursued. This article examines this less-traveled path to asset recovery and possible reasons pursuit of these claims is less common.

Prototypical Fraudulent Transfers

Section 548 of the Bankruptcy Code lays out the elements a party must satisfy to bring a successful fraudulent transfer claim in instances of both actual and constructive fraud. Actual fraud requires a finding that a transfer was made with "actual intent to hinder, delay, or defraud." Constructive fraud does not require a state of mind, but rather examines the transaction to determine whether the debtor received reasonably equivalent value for the transfer in conjunction with other factors such as whether the debtor was insolvent at the time of the transfer or became insolvent as a result of the transfer and whether the transfer was to or for the benefit of an insider.

In addition to Section 548 of the Bankruptcy Code, fraudulent transfer actions may be brought under state law pursuant to Section 544 of the bankruptcy code. State fraudulent transfer laws vary slightly but generally assume the same underlying premise–if a debtor intended to actually defraud creditors, or received less than reasonably equivalent value for a transfer, those transactions can potentially be unwound by the bankruptcy court.

Causes of action under both the bankruptcy code and applicable state law are commonly brought in bankruptcy cases by Chapter 7 and Chapter 11 trustees, official creditors' committees (if standing is granted), and post-confirmation liquidating or litigation trusts (if such right and standing are conferred to the trust pursuant to the confirmed plan), with the hope of bringing value into the estate for the benefit of creditors.

Once a party successfully asserts a claim for fraudulent transfer under either Section 548 or Section 544 and applicable state law, Section 550 of the bankruptcy code is used to recover the transferred property. The transfer will be unwound and the asset that was improperly removed from the estate will once again become a part of the estate for the benefit of creditors.

Although fraudulent transfers come in all shapes and sizes, there are several recurring fact patterns that present some common fraudulent transfer red flags and typify the basis for a fraudulent transfer claim. For example, if a piece of real property is transferred to an insider for little or no consideration shortly before a bankruptcy petition is filed, and a claim is timely brought by a party with standing, the bankruptcy court might find the transfer was either actually or constructively fraudulent.

Another textbook example is when a significant sum of money is transferred to a director or an officer of a corporation, as either a gift, bonus, or loan, shortly before the corporation files for bankruptcy. If these fraudulent transfer claims are successfully pursued, the property, in these cases either the real property or the funds, would be returned to the bankruptcy estate and be available for possible liquidation and distribution to creditors.

Forgiveness as Seldom-Pursued Fraudulent Transfer

Now consider the following scenarios, where the transferred assets are receivables of the future bankruptcy debtor rather than tangible assets: A company, in its business judgment as a solvent entity, loans monies to certain of its directors and officers and sets a formal schedule for repayment of the loans with interest. Similarly, a company might make intercompany loans and transfers to subsidiaries for operating expenses. In either case, the transfers are properly accounted for in the books and records of the company as receivables.

At some point thereafter, the officer, director, or subsidiary stops making payments on the debt and the company does not pursue the insider for repayment. Instead, prior to the bankruptcy petition, the company formally or informally either writes off the loan as uncollectible or forgives and cancels the loan. Eventually, the company becomes insolvent and files for bankruptcy, but the insiders do not become co-debtors.

The legal and factual fraudulent transfer analysis does not change drastically between the classic examples and the forgiveness or cancellation of debt fact patterns. The receivable—the right to collect monies from the loan recipient—is an interest of the debtor in property (the right to collect a receivable) that the debtor voluntarily removed from the estate prior to the petition date.

If the remaining requirements are satisfied, particularly the insolvency of the debtor at the time the debt was cancelled, and the cancellation occurred within the lookback period, the fraudulent transfer claim could theoretically be a source of significant revenue to the estate. Depending on the specific facts, either an actual fraudulent transfer or a constructive fraudulent transfer is plausible. Certain courts have confirmed that this avenue is viable. See, e.g., *Motorworld, Inc. v. Benkendorf*, 228 N.J. 311 (2017).

Aside from the similar legal analysis, the loan forgiveness scenarios "feel" the same as typical fraudulent transfers and have the same impact—those transactions leave creditors of the debtor holding the bag while the beneficiary of the transfer, in the above scenarios the debtor's directors, officers, and subsidiaries, continue on unaffected. In fact, the beneficiary of the transfer and its individual creditors will receive a windfall at the expense of the creditors of the debtor.

These scenarios are not uncommon; intercompany transfers are often considered within the ordinary course of business in a complex corporate structure, and loans to directors and officers are not rare. However, avoidance actions regarding forgiveness of debt are seldom brought.

One possible explanation is that there may not be a party with both sufficient information and standing to bring the claim. A debtor-in-possession does not have much incentive to affirmatively bring claims against its directors, officers, and affiliates. Unless a trustee or an official committee is appointed, which does not occur in every Chapter 11 case, there may be no party able to uncover and pursue the claims.

If a creditors' committee is appointed, it is likely the only party during the case with access to enough information to discover and pursue the claims, yet a creditors' committee does not have automatic standing to bring the claims. It must affirmatively seek the bankruptcy court's permission to bring the claims, adding a layer of cost and risk.

A post-confirmation fiduciary might similarly have the resources and information to bring the claims, but at that point it might be too late. If the confirmed plan released claims against the beneficiary of the transfer, either as a co-debtor or through a third-party release, or if standing to bring the claims is not affirmatively assigned to the post-confirmation fiduciary, that party might have its hands tied despite the potential value for creditors of the estate.

Even if standing could be ensured, the parties must know where to look to uncover the potential claims. Discovery of the fraudulent transfer claim will require access to and a detailed review of several years of accounting, a review and understanding of the intercompany complexities of the corporation and its operations, and an analysis of the claims' risks and potential value.

The investigation will also involve transparency or insight into the non-debtor transferee's books and records to determine whether the claims were properly deemed "uncollectible." A creditors' committee and post-confirmation fiduciary often have limited resources to fund their investigation and must make the difficult decision as to whether the risk outweighs the potential reward.

After a fraudulent transfer claim is discovered and a party is granted standing to pursue it, the party will likely expend substantial resources to continue analyzing the viability of the claim, and the associated risks and defenses, and ultimately litigate the claim. For example, the party will need to analyze the solvency of the debtor at the time the loan was forgiven–this analysis alone might be costly and require specialized or potentially expert assistance.

A debtor might also hide behind the "business judgment rule," which can be a challenge to overcome. In the end, the party might conclude that the possibility of recovery does not outweigh the risks and the party's limited resources are better used elsewhere, including potentially to be distributed directly to creditors.

A final possible explanation relates to the remedy–while through a successful traditional fraudulent transfer claim the result is property returning to the estate, the result of a loan forgiveness fraudulent transfer claim is a revival of the right to collect on the debt. Collection of the debt may present its own unique challenges whereby the creditors' committee, plan administrator, or trustee then transforms into a "debt collector" and may be faced with a legitimately uncollectible debt. In such instances, pursuing the claim will be for naught, as there will be no tangible recovery for creditors despite successfully proving the elements of a fraudulent transfer.

For each of the above reasons, in addition to other challenges, debt cancellation as a basis for a fraudulent transfer action is often overlooked, but that is not to say the potential for these actions is not common, viable, and valuable. A crucial first step in using these causes of action to bring value to the estate is to recognize them.

Parties considering value-driving claims against the estate should closely scrutinize any loans or other receivables involving insiders owed to the debtor. Next, parties must preserve these causes of action by taking necessary steps during the plan negotiation and confirmation stages, and when drafting trust agreements, to ensure the appropriate party will have the opportunity to bring these claims.