Constructive Fraudulent Transfer Claims Under Federal And State Law

Michael L. Cook
Abbey Walsh

Schulte Roth & Zabel LLP

Southeastern Bankruptcy Law Institute Seminar

April 12, 2007

Table of Contents

Table of Authorities

I. Cases

II. Statutes

III. Other Authorities

I. The Statutes

A. Codification of Law of Constructive Fraudulent Transfers

Claims to avoid constructive fraudulent transfers exist under (i) section 548 of the Bankruptcy Code (the "Code") and (ii) section 4(a)(2) of the Uniform Fraudulent Transfer Act (the "UFTA") and sections 4, 5 and 6 of the earlier Uniform Fraudulent Conveyance Act (the "USCA"). Code § 548 establishes a federal law of fraudulent transfers and enables the trustee to avoid transfers made and obligations incurred by the debtor within two years of the filing of a bankruptcy petition by or against the debtor. The UFTA was approved by the National Conference of Commissioners on Uniform State Laws in 1984 as a replacement for the USCA. Where adopted, both statutes provide state law claims for relief.[1] To date, at least thirty-nine states and the District of Columbia have adopted the UFTA.[2]

B. Basic Elements of Constructive Fraudulent Transfer

To state a constructive fraudulent transfer claim, the plaintiff must allege that (i) the transfer was made for "less than a reasonably equivalent value" *and* (ii) (a) the debtor is "insolvent"; (b) the debtor is inadequately capitalized; *or* (3) the debtor is about to incur debts "beyond [its] ability to pay" as they mature.[3]

C. Comparison of Code § 548(a)(1)(B) and UFTA § 4(a)(2)

i) Kojima v. Grandote Int'l. LLC (In re Grandote Country Club Co. Ltd.), 252 F.3d 1146, 1152 (10th Cir. 2001) ("[T]he language of [Code] § 548 and the relevant portions of the [Uniform Fraudulent Transfer Act] are quite similar . . . Because this language is nearly identical, the holding of [a case decided under Code § 548] logically applies to [a case governed by the Uniform Fraudulent Transfer Act].").

---

[1] The adoption of the UFTA by a state, however, does not pre-empt state common law remedies relating to fraudulent transfers. Fleet Nat'l Bank v. Valente (In re Valente), 360 F.3d 256, 261 (1st Cir. 2004) ("Our own case law rejects the proposition that the adoption of the UFTA by a state preempts all common law remedies relating to fraudulent transfers."). As shown below, the UFTA has had a significant impact on many other areas of law, especially leveraged buyouts, asset sales, and disputes with the Internal Revenue Service.

[2] A few jurisdictions (e.g., New York, Maryland) still follow the UFCA instead of the UFTA. The chief distinction between constructive fraudulent transfers under the UFCA and constructive fraudulent transfers under the Code and the UFTA: under UFCA a transfer must be made for "fair consideration," which is defined by UFCA § 3 as reasonably equivalent value plus "good faith." The Code and the UFTA have no good faith requirement.

[3] 11 U.S.C. §§ 548(a)(1)(B)(i), (ii)(I), (II) and (III). For cases commenced on or after April 20, 2005, the 2005 Amendments to the Code also enable the trustee to avoid an insider transfer pursuant to an employment contract if the transfer was made outside the ordinary course of business: "[t]he trustee may avoid any transfer…if the debtor received less than a reasonably equivalent value" and "made such transfer to or for the benefit of an insider…under an employment contact and not in the ordinary course of business." 11 U.S.C. § 548(a)(1)(B)(ii)(IV) This avoidance power does not require proof of insolvency.

ii) Transfers by insolvents: UFTA section 5(a) contains provisions similar to Code § 548(a)(1)(B)(i)-(ii)(I). See Cook, Michael L., Fraudulent Transfers, Understanding the Basics of Bankruptcy and Reorganization, 391-500, 455 (Practising Law Institute 2006).

iii) Transfers by persons in business: UFTA § 4(a)(2)(i) is similar to Code § 548(a)(1)(B)(i)-(ii)(II).

iv) Transfers by persons about to incur debts: UFTA § 4(a)(2)(ii) is similar to Code § 548(a)(1)(B)(ii)(III)

II. The Elements

A. Reasonably Equivalent Value

i) To describe the adequacy of the property exchanged in the fraudulent transfer context, Code § 548 uses "reasonably equivalent value" instead of the former Bankruptcy Act's "fair consideration," a term still used by the UFCA. The significant difference between the two standards: the Code and the UFTA eliminate the "good faith" requirement contained in UFCA § 3. As defined in Code § 548(d)(2)(A), "'value' means property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor."

ii) The "concept of reasonably equivalent value unfortunately has not been defined in the Code. . . . 'Congress left to the courts the obligation of marking the scope and meaning of [reasonably equivalent value].'" Mellon Bank v. Official Comm. of Unsecured Creditors of R.M.L., Inc. (In re R.M.L., Inc.), 92 F.3d 139, 148 (3d Cir. 1996) (alterations in original) (citations omitted). Any test for reasonably equivalent value under Code § 548 will necessarily encompass many of the same elements found in prior case law. Whether reasonably equivalent value has been given for a transfer of property is a question of fact. See Wilkinson v. John Wiley & Sons, Inc. (In re Wilkinson), 196 F.App'x 337, 341 (6th Cir. 2006) (determination of whether value was given under section 548 "depends on the circumstances of each case and not a mathematical formula."); Barber v. Golden Seed Co., 129 F.3d 382, 387 (7th Cir. 1997) ("[T]he formula for determining reasonably equivalent value is not a fixed mathematical formula; rather, the standard for '[r]easonable equivalence should depend on all the facts of each case. . . .'") (alteration in original); Texas Truck Ins. Agency, Inc. v. Cure (In re Dunham), 110 F.3d 286, 288-89 (5th Cir. 1997) (held, clearly erroneous standard is a proper standard to review reasonably equivalent value determination); Gaudet v. Babin (In re Zedda), 103 F.3d 1195, 1206 (5th Cir. 1997) ("Whether a transfer is made for a reasonably equivalent value is, in every case, largely a question of fact."); Nordberg v. Arab Banking Corp. (In re Chase & Sanborn Corp.), 904 F.2d 588, 593 (11th Cir. 1990); Jacoway v. Anderson (In re Ozark Restaurant Equip. Co.), 850 F.2d 342, 344 (8th Cir. 1988); Gray v. Snyder, 704 F.2d 709 (4th Cir. 1983); Consove v. Cohen (In re Roco Corp.), 701 F.2d 978, 981 (1st Cir. 1983); Klein v. Tabatchnick, 610 F.2d 1043, 1047 (2d Cir. 1979); Halsey v. Winant, 258 N.Y. 512, 523, 180 N.E. 253, cert. denied, 287 U.S. 620 (1932). Cf. Mellon Bank, N.A. v. Official Comm. of Unsecured Creditors of R.M.L., Inc. (In re R.M.L., Inc.), 92 F.3d 139, 147 (3d Cir. 1996) (whether debtor "was insolvent or received 'less than fair consideration' are mixed questions of law and fact").

iii) The trustee bears the burden of proving lack of reasonably equivalent value under Code § 548. Barber v. Golden Seed Co., 129 F.3d at 387. Important elements of determining equivalence include fair market value and "whether the sale was 'an arm's length transaction between a willing buyer and a willing seller.'" Id. (quoting Bundles v. Baker (In re Bundles), 856 F.2d 815, 824 (7th Cir. 1988)).

iv) Consideration sufficient to support an ordinary contract, i.e., "good" consideration, for contract law purposes will not necessarily be "fair" consideration or constitute reasonably equivalent value for fraudulent transfer purposes. Cohen v. Sutherland, 257 F.2d 737, 742 (2d Cir. 1958); HBE Leasing Corp. v. Frank, 61 F.3d 1054, 1060 (2d Cir. 1995) ("contingent property interests relinquished" by fiancé in prenuptial agreement with judgment debtor held not to constitute 'fair consideration' under fraudulent transfer law).

v) The relevant date for determining fairness of consideration is that of the transfer; subsequent depreciation or appreciation of the value of the consideration does not affect its adequacy for purposes of Section 548. Cooper v. Ashley Communications, Inc. (In re Morris Communications NC, Inc.), 914 F.2d 458, 475 (4th Cir. 1990) (fact that stock appreciated substantially after purchase is not ground for invalidating sale; "critical time for judging the propriety of the sale was the time of the sale"); Greene v. Newman (In re Newman), 15 B.R. 658 (S.D.N.Y. 1981) (present value of note payable over period of years must be assessed in order to determine whether value of consideration given in exchange for note is sufficient). When determining reasonable equivalent value, court should consider value at the time the obligations arose. See Federal Communications Comm'n v. Nextwave Personal Communications, Inc. (In re Nextwave Personal Communications, Inc.), 200 F.3d 43, 56 (2d Cir. 1999), cert. denied, 121 S. Ct. 298 (2000) (based upon FCC's interpretation of its own regulations, as supported by principles of auction law, auction sets fair market value of licenses because debtor incurred obligation at close of auction); contra, In re GW1 PCS 1 Inc., 230 F.3d 788, 810 (5th Cir. 2000) ("C-block auction was not a typical auction. Under the C-block auction rules, the winning bidder is not entitled to the license until after receiving subsequent FCC approval and does not become obligated for the full bid price until the notes securing the full bid price are thereafter signed.").

B. Financial Condition of the Debtor

i) Transfers By Insolvents. Under Code §§ 548(a)(1)(B)(i)-(ii)(I), a transfer of an interest in property or an incurrence of an obligation is voidable if a debtor receives "less than reasonably equivalent value" for the transfer and was "insolvent on the date that such transfer was made . . . , or became insolvent as a result of such transfer . . .." When asserting a constructive fraudulent transfer under Code § 548(a)(1)(B)(ii)(I) insolvency is a necessary element. See Dunham v. Kisak, 192 F.3d 1104, 1110 (7th Cir. 1999) (transfer of debtor's interest would not be set aside as fraudulent transfer when record contained no evidence that debtor was insolvent; "Insolvent" means debts "greater than all" assets (less exempt property), "at a fair valuation . . .." Code § 101(32(A)). The trustee need not allege or prove the existence of an actual creditor at the time of transfer by the insolvent. The elements of constructive fraud under Code §§ 548(a)(1)(B)(i)-(ii)(I) are the easiest of the operative fraudulent transfer claims to prove -- all of the elements (insolvency and less than reasonably equivalent value) are objective.

ii) Transfers By Persons In Business (Undercapitalized Debtors). A transfer of an interest in property is voidable under Code §§ 548(a)(1)(B)(i)-(ii)(II) if made in exchange for less than reasonably equivalent value *and* the debtor:

> 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.

Insolvency need not result from such a transfer or incurrence to make it fraudulent. See Steph v. Branch, 255 F. Supp. 526 (E.D. Okla. 1966), aff'd, 389 F.2d 233 (10th Cir. 1968). Moreover, the absence of fraudulent intent will not prevent a transfer under this section from being constructively fraudulent. Fidelity Trust Co. v. Union Nat'l Bank, 313 Pa. 467, 169 A. 209 (1933), cert. denied, 291 U.S. 680 (1934). Unreasonably small capital may be found under Code § 548(a)(B)(ii)(II) even if the enterprise continues on the same scale after the transfer; leveraged acquisitions are particularly prone to that possibility. See United States v. Gleneagles Inv. Co., 565 F. Supp. 556 (M.D. Pa. 1983) (company rendered insolvent by grant of mortgages given to finance leveraged buy-out because it deprived the company of cash flow, even though the company continued to operate after the buy-out), aff'd sub nom. United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986), cert. denied, 483 U.S. 1005 (1987); Wells Fargo Bank v. Desert View Bldg. Supplies, Inc. (In re Desert View Bldg. Supplies, Inc.), 475 F. Supp. 693, 697 (D. Nev. 1978) (holding that loan taken by subsidiary to repay parent's debt left the subsidiary with "'low' or 'extremely low' [cash on hand] for a business of its size…plac[ing] it in a situation where it had little working capital at a time when it needed to expand its sales"), aff'd mem., 633 F.2d 225 (9th Cir. 1980); In re Atlas Foundry Co., 155 F. Supp. 615 (D.N.J. 1957). But see Moody v. Security Pacific Business Credit, Inc., 971 F.2d 1056, 1073 (3d Cir. 1992) (affirming district court's determination that debtor was not left with unreasonably small capital after LBO because of availability of line of credit, and that proper test under UFCA to determine whether unreasonably small capital remains after LBO is "reasonable forseeability" of failure of the acquisition.)

Proof of unreasonably small capital may be established by evidence showing that the debtor was constantly behind in paying its bills or that it continued its business under financial risk. Teitelbaum v. Voss (In re Tuller's, Inc.), 480 F.2d 49 (2d Cir. 1973) (holding that transfer left debtor "devoid of capital"); New York Credit Men's Adjustment Bureau, Inc. v. Adler, 2 B.R. 752, 756 (S.D.N.Y. 1980) (finding unreasonably small capital where debtor was "constantly behind in paying its bills"). But see Credit Managers Ass'n of Southern California v. Federal Co., 629 F. Supp. 175 (C.D. Cal. 1985) (held, business not undercapitalized for fraudulent transfer purposes; positive cash flow projections developed by lender at time of transfer found persuasive).

iii) Transfers By Persons About To Incur Debts. A transfer of property for less than reasonably equivalent value when the debtor:

> 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

may also be avoided under Code § 548(a)(1)(B)(ii)(III). See generally Pirrone v. Toboroff (In re Vaniman Int'l, Inc.), 22 B.R. 166, 188 (Bankr. E.D.N.Y. 1982) (citing Carpenter v. Roe, 10 N.Y. 227, 231-32 (1851)); Steph v. Branch, 255 F. Supp. 526 (E.D. Okla. 1966), aff'd 389 F.2d 233 (10th Cir. 1968). Intent for purposes of that section must occur contemporaneously with the transfer or incurrence; proof of a chronological link between the transfer and subsequently incurred debts will not suffice. 5 Collier, Bankruptcy, ¶ 548.05, at 548-30 (Lawrence P. King ed., 15th rev. ed. 1997). It is not necessary, however, to prove knowledge of inability to pay particular debts; general intent is enough. Lackawanna Pants Mfg. Co. v. Wiseman, 133 F.2d 482 (6th Cir. 1943). This type of transfer is rarely alleged on a stand-alone basis, and is usually asserted as a make-weight with other claims.

III. Challenging and Defending Guaranties and Co-Borrower Loan Structures

A. Indirect Benefits

i) The debtor may receive reasonably equivalent value through an indirect benefit conferred upon a third party. Frontier Bank. v. Brown (In re Northern Merchandise Inc.), 371 F. 3d 1056 (9th Cir. 2004) (held, corporate debtor's receipt of proceeds from loan made to its shareholders constituted "reasonably equivalent value" in exchange for security interest debtor granted to lender because the value of the security interest was equivalent to the benefit that the debtor received from the loan); Field v. United States (In re Abatement Envtl. Res., Inc.), 102 Fed. Appx. 272, 277 (4th Cir. 2004) (fair consideration may exist when "the consideration given to the third person has ultimately landed in the debtor's hands, or if the giving of the consideration to the third person otherwise confers an economic benefit upon the debtor."); Leibowitz v. Parkway Bank & Trust Co. (In re Image Worldwide, Ltd.), 139 F.3d 574, 582 (7th Cir. 1998) ("indirect benefits to guarantor may be considered when determining whether a corporation receives reasonably equivalent value for a guarantee"; bankruptcy court did not clearly err in finding that debtors' guarantees of affiliates' obligations to bank were fraudulent transfers in violation of UFTA because debtor corporation "did not receive reasonably equivalent value for its guarantees"); HBE Leasing Corp. v. Frank, 48 F.3d 623, 639 (2d Cir. 1995) (judgment debtor received fair consideration for its payments to attorneys for its codefendants in RICO action; "multiple co-defendants . . . threatened with joint and several liability . . . mounted a common defense, and one defendant paid the legal fees of the others …."); Rubin v. Manufacturers Hanover Trust Co., 661 F.2d 979, 991 (2d Cir. 1981) (fair consideration may exist when "the consideration given to the third person has ultimately landed in the debtor's hands, or if the giving of the consideration to the third person otherwise confers an economic benefit upon the debtor"); In re Van Dyck/Columbia Printing, 263 B.R. 167, 176 (D. Conn. 2001) ("Section 548 provides for avoidance of a transfer only if 'the debtor . . . received less than a reasonable equivalent in exchange' for that transfer. In other words, the statutory focus is on what the debtor received, not from whom it was received."), aff'd in relevant part by 289 B.R. 304 (D. Conn. 2003); Corporate Jet Aviation, Inc. v. Vantress (In re Corporate Jet Aviation, Inc.), 57 B.R. 195 (Bankr. N.D. Ga. 1986), aff'd, 82 B.R. 619 (N.D. Ga. 1987), aff'd, 838 F.2d 1220 (11th Cir. 1988). Indirect benefit or value may exist in the form of additional business opportunities that existing lines of credit make available or, in the LBO context, the synergies that may result from the acquisition. Mellon Bank, N.A. v. Metro Communications, Inc., 945

F.2d 635, 647 (3d Cir. 1991), cert. denied sub nom. Committee of Unsecured Creditors v. Mellon Bank, 503 U.S. 937 (1992); but cf. United States v. Gleneagles Inv. Co., 565 F. Supp. 556 (M.D. Pa. 1983), rev'd sub nom. United States v. Tabor Court Realty Corp., 803 F.2d 1988 (3d Cir. 1986), cert denied sub nom. McClellan Realty Co. v. United States, 483 U.S. 1005 (1987).

ii) Transfers made solely for the benefit of third parties, however, are not for reasonably equivalent value. Butler v. Nationsbank, N.A., 58 F.3d 1022, 1029 (4th Cir. 1995); Klein v. Tabatchnick, 610 F.2d 1043, 1047 (2d Cir. 1979); Central Nat'l Bank v. Coleman (In re B-F Building Corp.), 312 F.2d 691, 694 (6th Cir. 1963) ("In the usual case . . . the payment of another's debt is held to be a transfer without fair consideration."); William Iselin & Co. v. Boardwalk Regency Corp., 703 F. Supp. 1084, 1087 (S.D.N.Y. 1989) (corporation did not receive fair consideration when controlling individual's use of corporate checks to pay his personal gambling debts bestowed no benefit upon corporation); Hall v. Arthur Young & Co. (In re Computer Universe, Inc.), 58 B.R. 28 (Bankr. M.D. Fla. 1986) (payment of shareholder debt by corporation is generally avoidable by trustee, unless debtor received benefit of original consideration); Gill v. Brooklier (In re Burbank Generators, Inc.), 48 B.R. 204 (Bankr. C.D. Cal. 1985) (payment by debtor corporation of employee's legal fees with respect to racketeering charges was solely for benefit of employee). The Fifth Circuit, however, has ruled that much hoped for and anticipated future business opportunities constituted reasonably equivalent value, even though the business opportunities never materialized. Butler Aviation Int'l, Inc. v. Whyte (In re Fairchild Aircraft Corp.), 6 F.3d 1119, 1126-27 (5th Cir. 1993) (aircraft manufacturer's payments for commuter airline's fuel in attempt to keep airline afloat constituted reasonably equivalent value when (i) commuter airline was part of USAir system and manufacturer viewed USAir as "potential major customer," and (ii) keeping airline "marketable" gave manufacturer opportunity to recoup its investment and make additional sales in event that buyer could be found).

iii) Reasonably equivalent value in the case of a "downstream" transfer, i.e., a transfer from a parent to a wholly-owned subsidiary, is easily shown, at least in situations when (a) the subsidiary/transferee is solvent and adequately capitalized, and (b) the transfer to the subsidiary is not part of a series of transactions that has the effect of removing value from the reach of the parent's creditors. Thus, the parent's ownership interest in a wholly-owned, solvent subsidiary usually assures that the parent will be found to have benefited from any benefit conferred upon the subsidiary as a result of the transfer. See, e.g., Lawrence Paperboard Corp. v. Arlington Trust Co. (In re Lawrence Paperboard Corp.), 76 B.R. 866, 871 (Bankr. D. Mass. 1987). See also Rosenberg, Intercorporate Guaranties And The Law Of Fraudulent Conveyances: Lender Beware, 125 U. Pa. L. Rev. 235, 238 (1976). But see Orr v. Kinderhill Corp., No. 91-CV-353 (N.D.N.Y. March 30, 1992) (in voiding bank's liens against certain real estate that had formerly been owned by corporate parent and then transferred to its subsidiary, parent's transfer of real property to its newly-formed wholly-owned subsidiary was not supported by fair consideration, although value of stock presumably increased as result of transfer), aff'd on other grounds, 991 F.2d 31 (2d Cir. 1993) (court found it unnecessary to address question of whether transfer to wholly-owned subsidiary was fraudulent *per se* because transfer by parent to its subsidiary while litigation pending against parent was but one of a series of restructuring steps that had effect of removing property's value from reach parent's creditors). If the subsidiary is insolvent, however, it may be impossible to show that the parent benefited from the downstream transfer. See Commerce Bank v. Achtenberg, No. 90-0950-CV-W-6, 1993 U.S. Dist. LEXIS

16136, at *4 (W.D. Mo. Nov. 10, 1993) (no presumption of reasonably equivalent value when parent guaranteed loan to insolvent subsidiary); Murphy v. Avianca, Inc. (In re Duque Rodriguez), 77 B.R. 937 (Bankr. S.D. Fla. 1987) (transfer by parent on behalf of insolvent subsidiary diminished net worth of parent and was not made for reasonably equivalent value).

iv) An "upstream" transfer for the benefit of a third party--i.e., from a subsidiary to a parent, will be more likely to lack reasonably equivalent value, as will the guaranty by a subsidiary of a parent's obligation and a "cross-stream" transfer (i.e., from one subsidiary to another.) See, e.g., In re FBN Food Services, Inc., 82 F.3d 1387, 1393-94 (7th Cir. 1996) (trustee sued debtor's shareholder, shareholder's corporate parent and others, alleging that transfer of settlement proceeds to corporate parent was fraudulent transfer; court affirmed avoidance of transfer; restaurant franchisor paid portion of debtor's settlement proceeds to debtor's shareholder, and corporate parent applied that amount to reduce debt on loan it made to another company in which shareholder held interest); Clark v. Security Pacific Business Credit, Inc. (In re Wes Dor, Inc.), 996 F.2d 237, 243 (10th Cir. 1993) (pledge of subsidiary's assets to secure parent's outstanding loans was fraudulent transfer); Central Nat'l Bank v. Coleman (In re B-F Bldg. Corp.), 312 F.2d 691, 694 (6th Cir. 1963) (cross-stream transfer held fraudulent, when debtor corporation granted lien on its property to bank in exchange for bank's release of note executed by affiliated corporation). Equivalent value can nevertheless be found in such transactions when, for example,

(a) The transferor received an indirect benefit. See, e.g., Harman v. First American Bank of Md. (In re Jeffrey Bigelow Design Group, Inc.), 956 F.2d 479, 481 (4th Cir. 1992) (no fraudulent transfer by debtor found where debtor guaranteed its shareholders' line of credit agreement with bank because although shareholders were borrowers under line of credit, "only the debtor received the draws and all payments were made directly from the debtor to [the bank]"). But see Rubin v. Manufacturers Hanover Trust Co., 661 F.2d 979, 991-93 (2d Cir. 1981) (court reversed and remanded district court's finding that fair consideration existed in "three-sided transaction" because although "debtor may sometimes receive 'fair' consideration even though the consideration given for his property or obligation goes initially to a third person, "existence of any indirect benefit whatever does not necessarily support finding of fair consideration and court must analyze whether benefit received was "disproportionately small" when compared with size of security that debtor gave and obligations it incurred).

(b) The corporate entities are collapsed (i.e., treated as alter egos or consolidated) if affiliated entities are actually the same for purposes of the transaction: funds advanced to one will be equivalent value for a payment made or security interest given by the other. See Mayo v. Pioneer Bank & Trust Co., 270 F.2d 823 (5th Cir. 1959), cert. denied, 362 U.S. 962 (1960); Telefest, Inc. v. VU-TV, Inc., 591 F. Supp. 1368 (D.N.J. 1984) (in dicta, court stated that B-F Building rule is inapplicable "'if the debtor and the third party are so related or situated that they share an 'identity of interests', because what benefits one, will in such case, benefit the other to some degree.'" (citation omitted)); McNellis v. Raymond, 287 F. Supp. 232 (N.D.N.Y. 1968), aff'd in relevant part, 420 F.2d 51 (2d Cir. 1970) (court found "identity of interest" where loan payments were made by debtor to creditor for loans originally made to debtor's corporation and therefore fair consideration); In re Nelsen, 24 B.R. 701, 702 (N.D. Or.

1982) ("Where there is sufficient commingling of the affairs of a debtor with the affairs of a third party to establish 'identity of interest', the Court may, under compelling circumstances, ignore the separate existence of two debtors for the purpose of finding a transfer to both debtors of equivalent value"; identity of interest not established where wife guaranteed debts of a corporation in which her husband was principal; marriage alone not sufficient.)

B. Timing of Transfer

i) In Rubin, the court held that a guaranty of a revolving line of credit given outside of the fraudulent transfer reach-back period could be attacked as a fraudulent transfer to the extent that the revolving line was drawn during the reach-back period. Id. at 989-991.

ii) In an effort to overturn Rubin, Section 6(5) of the UFTA provides that "an obligation is incurred: (i) if oral, when it becomes effective between the parties; or (ii) if evidenced by a writing, when the writing executed by the obligor is delivered to or the benefit of the obligee." See Comment, UFTA § 6 ("Paragraph (5) is new. It is intended to resolve uncertainty arising from Rubin, insofar as that case holds that an obligation of guaranty may be deemed to be incurred when advances covered by the guaranty are made rather than when the guaranty first became effective between the parties. Compare Rosenberg, Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware, 125 U.Pa.L.Rev. 235, 256-57 (1976)."). Id. at 989-91, 997.

iii) There is no existing case law, however, applying UFTA § 6(5) to a fact pattern such as the one presented in Rubin.

C. Efficacy of Fraudulent Transfer Savings Clauses

i) Each of the fraudulent transfer statutes contains a "savings clause" that protects good faith initial transferees to the extent they give value to the debtor. Code § 548(c); UFTA § 8; UFCA § 9. Code § 548(c) provides in relevant part: "a transferee... that takes for value and in good faith has a lien on… to the extent that such transferee… gave value to the debtor in exchange for such transfer… ." Because this section is in the nature of an affirmative defense, the burden of proof is ordinarily on the transferee to show that he received the transfer in good faith *and* that it gave value. See In re Hanover, 310 F. 3d 796, 799 (5th Cir. 2002). To determine whether a transferee acts in good faith, courts look to what the transferee objectively "knew or should have known"; transferee does not act in good faith if it is on inquiry notice of debtor's possible insolvency. In re Sherman, 67 F. 3d 1348, 1355 (8th Cir. 1995) (affirming bankruptcy court holding denying § 548(c) lien on property for transferees because they were debtor's parents and knew of debtor's financial difficulties).

ii) A contractual savings clause commonly used by lenders limits the guarantor's fraudulent transfer liability to a fixed amount: the amount guaranteed. See Michael F. Maglio, *The Promise, Part II: Corporations, Obligations and Fraudulent Conveyances*, 14-FEB Bus. L. Today, 25, 31 (2005) (discussing techniques to limit a guarantor's liability). Savings clauses attempt to "save" a transaction that may otherwise be avoided entirely as a fraudulent transfer. Id. The efficacy of savings clauses, however, has not yet been determined by the courts. See In

re Exide Technologies, Inc., 299 B.R. 732, 748 (Bankr. D. Del. 2003) (noting that the party arguing for dismissal of fraudulent transfer claim failed to cite any decision in support of the efficacy of the "savings clause"); Maglio at 31 ("efficacy of a savings clause has not yet been determined.")

iii) In Exide the court was merely disposing of a lender's motion to dismiss the creditors' committee fraudulent transfer complaint. Exide, 299 B.R. at 748. The lenders argued that the savings clause (which limited each guarantee so that the maximum liability of each guarantor subsidiary "shall in no event exceed the amount which can be guaranteed by such Subsidiary Guarantor under applicable federal and state laws relating to insolvency of the debtors") destroyed the essential elements of the fraudulent transfer claim. Id. The court denied the lenders' dismissal motion because the clause limited the fraudulent transfer claim to an amount that would render the debtors solvent, an amount which had not yet been determined, and expressed no opinion on the efficacy of the clause. Id. at 748-9.

D. Proving Solvency/Insolvency.

i) The Code's definition of insolvency requires a simple "balance sheet" test and excludes from the fair value of the debtor's property any fraudulently transferred property as well as exempt property. Code § 101(32); Coleman v. Home Savs. Ass'n (In re Coleman), 21 B.R. 832, 835 (Bankr. S.D. Tex. 1982) ("[E]xempt property must be excluded when applying the balance sheet test for insolvency."). Contingent assets such as rights to contribution and subrogation must be valued for purposes of determining solvency. Manufacturers & Traders Trust Co. v. Goldman (In re Ollag Constr. Equip. Corp.), 578 F.2d 904, 908-09 (2d Cir. 1978). Contingent assets and liabilities, however, should not be considered at face value, but rather should be discounted by the probability that the contingency will materialize. See Covey v. Commercial Nat'l Bank of Peoria, 960 F.2d 657 (7th Cir. 1992) (contingent liability should be determined by multiplying total debt guaranteed by probability that debtor would be required to make good on guarantee); Nordberg v. Arab Banking Corp. (In re Chase & Sanborn Corp.), 904 F.2d 588, 594 (11th Cir. 1990); In re Xonics Photochemical, Inc., 841 F.2d 198, 200 (7th Cir. 1988); see, e.g., Travellers Int'l AG v. Trans World Airlines, Inc. (In re Trans World Airlines, Inc.), 134 F.3d 188, 197-198 (3d Cir. 1998) (deposit voidable as preference when debtor insolvent on date of transfer because value of debtor's liabilities exceeded that of its assets; "it is proper to consider contingent liabilities when evaluating the insolvency of a corporation pursuant to 11 U.S.C. § 101(32)(A)"; in treating debtor as going concern, court limited contingent liabilities to costs arising from foreseeable events that might occur while debtor remains in business), cert. denied, 118 S. Ct. 1843 (1998); Federal Deposit Ins. Corp. v. Bell, 106 F.3d 258, 264 (8th Cir. 1997) ("To correctly 'value the contingent liability it is necessary to discount it by the probability that the contingency will occur and the liability become real.'"), quoting In re Xonics Photochemical, Inc., 841 F.2d 198, 200 (7th Cir. 1988)); Mellon Bank, N.A. v. Official Comm. of Unsecured Creditors of R.M.L., Inc. (In re R.M.L., Inc.), 92 F.3d 139, 155-156 (3d Cir. 1996) ("[I]f a debtor's treatment of an item as an 'asset' depends for its propriety on the occurrence of a contingent event, a court must take into consideration the likelihood of that event occurring from an objective standpoint," when making solvency determination on fraudulent transfer claim; under balance sheet test, "'assets and liabilities are tallied at fair valuation to determine whether the corporation's debts exceed its assets'" (quoting Mellon Bank, N.A. v. Metro Communications, Inc., 945 F.2d 635, 648 (3d Cir. 1991), cert. denied, 503 U.S. 937

(1992)); Official Comm. of Asbestos Personal Injury Claimants v. Sealed Air Corp. (W.R. Grace & Co.), 281 B.R. 852, 869 (Bankr. D. Del. 2002) (held, disposing of in limine motion, court relied on hindsight to find insolvency; "asbestos claims filed [against the debtor] after the transfer date may be considered in determining the debtor's solvency [on] the transfer date."); but see Lippe v. Bairnco Corp., 99 Fed. Appx. 274, 282 (2d Cir. 2004) (rejecting argument that under New York's version of the UFCA, "future claims" must be included when calculating solvency; "[T]he hypothetical existence of an unaccrued tort claim does not give rise to a debtor-creditor relationship. There is no existing debt.").

ii) Under Code § 548, "solvency is measured at the time the debtor transferred value, not at some later or earlier time." Mellon Bank, N.A. v. Official Comm. of Unsecured Creditors of R.M.L., Inc., 92 F.3d 139, 154 (3d Cir. 1996). Unlike a preference action[4], however, there is no presumption of insolvency in a fraudulent transfer action. Thus, proof by direct evidence of the insolvency of the debtor on the critical date of the transfer may be more difficult; "insolvency frequently must be determined by proof of . . . factors from which insolvency may be inferred." Constructora Maza, Inc. v. Banco de Ponce, 616 F.2d 573, 577 (1st Cir. 1980); see also Achille Bayart & CIE v. Crowe, 238 F.3d 44, 48 (1st Cir. 2001) ("The plaintiff has the burden of proving that there was some determinable amount of value in the assets of the debtor over and above the amount of the secured debt."). The trustee must still prove "fair value" of the debtor's property, particularly because "book value" may not reflect "the property's fair value." Orix Credit Alliance, Inc. v. Harvey (In re Lamar Haddox Contractor, Inc.), 40 F.3d 118, 121-22 (5th Cir. 1994) (accountant's "conclusory opinion testimony . . . without any [supporting] evidence" will be insufficient when there are "substantial questions . . . as to the fair value of the Debtor's property.").

iii) The UFTA contains a new definition of insolvency: a "balance sheet" definition similar to that contained in the Code with a twist. Under UFTA § 2, a debtor is insolvent if the sum of its debts is greater than that of its assets "at a fair valuation," a term left undefined by the UFTA. In addition, UFTA § 2(b) contains a rebuttable presumption of insolvency when a debtor is generally not paying its debts as they become due.

iv) The debtor's "assets" in UFTA § 1(2) *exclude* (i) an interest in property held by the entireties to the extent that a creditor with a claim against only one of the tenants may not reach such property;[5] (ii) property to the extent encumbered by a valid lien (but, under UFTA § 2(e), debts are not included to the extent that they are secured by property thus excluded); and (iii) property "to the extent it is generally exempt under nonbankruptcy law." Comment (1) accompanying UFTA § 2 states that this latter exclusion applies not only to property that a debtor may exempt from creditor process under homestead and other exemption laws, but also to an interest in a valid spendthrift trust.

---

[4] "For the purposes of this [preference] section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition." 11 U.S.C. § 547(f).

[5] See Macdonald v. Gayton, 469 F.3d 1079 (7th Cir. 2006) (held, despite debtor's fraudulent transfer of jointly held interest in property (tenancy by entirety), transfer not voidable because debtor died, enabling surviving spouse to extinguish "any rights" judgment creditor may have had). But see United States v. Craft, 535 U.S. 274 (2002) (federal tax liens may attach to property held by tenancy by the entirety).

v) The UFTA's definition of insolvency makes it easier for creditors to prove a fraudulent transfer when insolvency is a material element. The plaintiff creditor need only show, in most cases, that the debtor has generally stopped paying its debts as they become due, placing the burden of proving solvency on the debtor.

vi) Retrojection. Courts have used the term "retrojection" to describe the process of working backwards from the time of the avoidance action to the date of the transfer to show facts from which the debtor's insolvency may be presumed. See, e.g., Briden v. Foley, 776 F.2d 379 (1st Cir. 1985); Misty Management Corp. v. Lockwood, 539 F.2d 1205, 1213 (9th Cir. 1976). When using the accounting technique of retrojection to prove insolvency, however, the trustee must show the absence of any substantial or radical changes in the assets or liabilities of the debtor between the retrojection dates. Hassan v. Middlesex County Nat'l Bank, 333 F.2d 838, 840 (1st Cir. 1964) ("Insolvency is not always susceptible of direct proof and frequently must be determined by the proof of other facts or factors from which the ultimate fact of insolvency on the transfer dates must be inferred or presumed"; therefore trustee should have been allowed to present all evidence in using retrojection method to show that debtor was insolvent.); Kanasky v. Randolph (In re R. Purbeck & Assocs., Ltd.), 27 B.R. 953 (Bankr. D. Conn. 1983) (where only evidence presented was testimony that debtor received a capital investment between retrojection dates held not sufficient to prove insolvency).

E. Common Enterprise/Synergy Defense

i) In determining whether "reasonably equivalent value" is given in the context of a leveraged buyout ("LBO")[6], courts have held that the "synergistic" effects of an acquisition may constitute an indirect benefit to the debtor. Mellon Bank, N.A. v. Metro Communications, Inc., 945 F.2d 635, 647 (3d Cir. 1991); see also MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Services Co., L.P., 910 F. Supp. 913 (S.D.N.Y. 1995) (recognizing synergistic effects of new corporate relationships to be indirect benefits when calculating reasonably equivalent value in LBOs); Fidelity Bond and Mortgage Co. v. Brand (In re Fidelity Bond and Mortgage Co.), 340 B.R. 266, 288 (Bankr. E.D. Pa. 2006) (no reasonably equivalent value found to be conferred on debtor in corporate merger when merger left debtor with additional secured indebtedness, a line of credit that was not accessible immediately, and the net worth of target company was less than bargained for, thus decreasing the chances that the new entity would recognize value from the synergies). When there was a only mere expectation that the fusion of two companies would produce a strong synergy that turned out to be inaccurate in hindsight, courts have held that the expectation can suffice to confer value, so long as there is some chance that a contemplated investment will generate a positive return at the time of the disputed transfer. See Mellon Bank, N.A. v. Official Committee of Unsecured Creditors of R.M.L., Inc. (In re R.M.L., Inc.), 92 F. 3d 139, 152 (3d Cir. 1996) (reviewing transaction at time transfer was made, court affirmed lower court's determination that commitment letter provided by bank to debtor in

[6] "A leveraged buyout refers to the acquisition of a company ('target corporation') in which a substantial portion of the purchase price paid for the stock of a target corporation is borrowed and where the loan is secured by the target corporation's assets. Commonly, the acquiror invests little or no equity. Thus, a fundamental feature of leveraged buyouts is that equity is exchanged for debt." Mellon Bank, N.A. v. Metro Communications, Inc., 945 F.2d 635, 645 (3d Cir. 1991).

connection with loan conferred "reasonably equivalent value," because there was at least some chance of receiving future economic benefit).

IV. Challenging and Defending Pre-Bankruptcy Foreclosures

A. Real Property

i) Prior to enactment of the Bankruptcy Amendments and Federal Judgeship Act of 1984, a conflict among the circuits existed on the issue of when a transfer occurs in the context of a mortgage foreclosure sale of a debtor's property. Compare Madrid v. Lawyers Title Ins. Corp. (In re Madrid), 725 F.2d 1197 (9th Cir. 1984), cert. denied, 469 U.S. 833 (1984) (transfer made for the purposes of Code § 548(d)(1) when the mortgagee's security interest is perfected by recording of the deed of trust (in Madrid, more than a year prior to bankruptcy, so that the transfer could not be avoided), and not when the property is sold at foreclosure) with Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201 (5th Cir. 1980) (decided under section 67(d)(5) of former Bankruptcy Act, forerunner of Code § 548(d)(1); foreclosure sale less than one year before bankruptcy may be set aside as fraudulent, although mortgage recorded more than one year prior to bankruptcy); Abramson v. Lakewood Bank & Trust Co., 647 F.2d 547 (5th Cir. 1981) (affirming Durrett), cert. denied, 454 U.S. 1164 (1982); First Fed. Savs. & Loan Ass'n of Bismarck v. Hulm (In re Hulm), 738 F.2d 323 (8th Cir. 1984), cert. denied, 469 U.S. 990 (1984) (not citing Durrett, but expressly declining to follow Madrid) (foreclosure of mortgage under North Dakota statutory scheme effects transfer within meaning of Code § 548(d)(1) and may therefore be avoided under Code § 548(a)).

ii) In the 1984 amendments Congress added the words "and foreclosure of the debtor's equity of redemption" to the definition of transfer in Code § 101(54).[7] Although this change seems, objectively, to side with Durrett, it was originally part of a legislative package designed to overrule it. See Verna v. Dorman (In re Verna), 58 B.R. 246, 251 (Bankr. C.D. Cal. 1986) (held, third party purchaser of property at a noncollusive and regularly conducted foreclosure sale purchases property for reasonably equivalent value required by section 548); see also Alden, Gross & Borowitz, The Durrett Controversy And Foreclosure Sales, N.Y.L.J., Nov. 14, 1984, at 33, col. 1; Berman & Fierberg, Durrett, The Problem And Suggestions For Its Solution, 90 Com. L.J. 162 (1985).

iii) The Supreme Court resolved the Durrett problem, holding that "reasonably equivalent value" is always received in noncollusive foreclosure sale conducted in compliance with applicable state law. See BFP v. Resolution Trust Corporation, 511 U.S. 531, 545 (1994) (5-4 decision) (court held, resolving split among circuits, "we deem, as the law has always deemed, that a fair and proper price, or a 'reasonably equivalent value,' for foreclosed property, is the price in fact received at the foreclosure sale, so long as all the requirements of the State's foreclosure law have been complied with."). See also In re Winshall Settlor's Trust, 758 F.2d 1136, 1139 (6th Cir. 1985); Lawyers Title Ins. Corp. v. Madrid (In re Madrid), 21 B.R. 424 (B.A.P. 9th Cir. 1982), aff'd on other grounds, 725 F.2d 1197 (9th Cir. 1984), cert. denied, 469 U.S. 833 (1984). BFP therefore rejects holdings by lower courts that the amount received at a foreclosure sale is not necessarily reasonably equivalent value. See, e.g., Bundles v. Baker (In re

[7] The 2005 Amendments preserve this clarification.

Bundles), 856 F.2d 815 (7th Cir. 1988) (no irrebuttable presumption of reasonably equivalent value in noncollusive foreclosure sales).

iv) The presumption that the proceeds of a foreclosure sale, conducted in adherence to state law, constitute reasonably equivalent value has been adopted by the UFTA. Section 3(b) provides that for purposes of sections 4(a)(2) and (5) (constructively fraudulent transfers), "reasonably equivalent value" is given when a person acquires an asset of the debtor at "a regularly conducted, noncollusive foreclosure sale." Although the Durrett court, in dicta, implied that a transfer for less than 70% of fair market value lacked fair consideration, most courts following the Durrett rationale adopted a case-by-case approach on this particular issue. See Walker v. Littleton (In re Littleton), 888 F.2d 90, 93 (11th Cir. 1989); Grissom v. Johnson (In re Grissom), 955 F.2d 1440 at 1445-48 (S.D.Ga. 1992). A different panel of the Fifth Circuit even criticized its Durrett decision in view of contrary authorities in other circuits. Besing v. Hawthorne (In re Besing), 981 F.2d 1488, 1496, n. 14 (5th Cir. 1993) ("In Durrett v. Washington Nat'l Ins. Co. . . . a panel of this circuit applied a purely mathematical test, holding that a foreclosure sale which brought only 57.7 percent of the market value of a debtor's property was subject to avoidance. In so holding, the Durrett court also observed that it had found no case in which a transfer for less than 70 percent of market value had been approved. . . . This dictum spawned the so-called 'Durrett rule,' which, when mechanically applied, invalidates any transfer for less than 70 percent of fair market value . . . . Other circuits, indeed the majority of the circuits that have addressed the issue, reject Durrett's purely mathematical analysis in favor of a broader 'totality of the circumstances' standard.") (internal citations and citations of contrary authorities omitted).

v) Since BFP, several courts have inconsistently interpreted the Supreme Court's ruling. See Miller v. NLVK, LLC (In re Miller), 454 F.3d 899, 901-2 (8th Cir. 2006) (declining to extend BFP rule -- foreclosure price is reasonably equivalent value -- to postpetition foreclosure under § 549(c) of the Code and its requirement of "present fair equivalent value"). But see T.F. Stone Co. v. Harper, 72 F. 3d 466, 470-72 (5th Cir. 1995) (extending BFP's holding to § 549(c); holding postpetition tax foreclosure sale to be noncollusive and conducted in conformity with state law, thus satisfying requirement for "present and fair value"). See also In re Grandote Country Club Co., Ltd., 252 F. 3d 1146, 1152 (10th Cir. 2001) (extending BFP to tax sales context; held tax sale was a transfer for reasonably equivalent value because sale was regularly conducted under state law subject to a competitive bidding procedure); In re Erlewine, 349 F. 3d 205, 212 (5th Cir. 2003) (applying the reasoning in BFP, taking account of states' interests to uphold pre-bankruptcy judicial transfer of property during divorce proceeding).

B. Personal Property

i) The BFP rule was held to apply to real property mortgage foreclosures, but "[t]he considerations bearing upon other foreclosures and forced sales (to satisfy tax liens, for example) may be different." BFP, 114 S.Ct. at 1761, n. 3.

ii) No circuit court has considered the issue, but lower courts have declined to extend the BFP rule to foreclosure sales of personal property. See Case v. TBAC-Prince Gardner, Inc. (In re Prince Gardner, Inc.), 220 B.R. 63 (Bankr. E.D. Mo. 1998) (court declined to extend BFP holding to non-public forced foreclosure sale of inventory, trade names, customer

relationships, accounts receivable and fixed assets); Carter v. H&B Jewelry and Loan (In re Carter), 209 B.R. 732 (Bankr. D. Or. 1997) (holding that state's interest in protecting personal property was not as essential as the need, as in BFP, to protect real property titles and, therefore, a pawn shop transaction involving personal property was not insulated from being set aside as a fraudulent transfer)

V. **Challenging and Defending Leveraged Buy-Outs**

A. Relevance of Section 546: Safe Harbor

i) Actual Fraud Exception: Code § 546(e) excludes from a trustee's fraudulent transfer attack "margin payments" and "settlement payments" "by or to a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant[8] or securities clearing agency" (as such terms are defined in Code § 101) unless the payments were made with actual intent to hinder, delay, or defraud creditors under Code § 548(a)(1). 11 U.S.C. § 546(e); In re Manhattan Inv. Fund Ltd., 310 B.R. 500, 513 (Bankr. S.D.N.Y. 2002) (held; Code § 546(e) inapplicable when payments made as part of Ponzi scheme under Code § 548(a)(1)(A)), leave to appeal denied, 288 B.R. 52 (S.D.N.Y. 2002). A securities broker who innocently received funds on behalf of its customers in exchange for their stock in an LBO transaction was thus exonerated in Kaiser Steel Corporation v. Charles Schwab & Co., 913 F.2d 846 (10th Cir. 1990).

ii) Leveraged Buyouts: The Tenth Circuit also extended the protection of Code § 546(e) to the *selling* shareholders in an LBO. Kaiser Steel Co. v. Pearl Brewing Co. (In re Kaiser Steel Co.), 952 F.2d 1230 (10th Cir. 1991), cert. denied, 112 S. Ct. 3015 (1992). After finding Code § 546(e) to be clear on its face and refusing to delve into murky legislative history, the court concluded that "those shareholders who tendered their shares one day after the LBO and received the LBO consideration are treated just the same under the Code as shareholders who sold their shares in the market one day prior to the LBO and received a settlement payment reflecting the market value of the LBO consideration. Neither type of investor will be forced to disgorge the payment several years later." Id. at 22. The court viewed its decision as consistent with Congressional policy to promote finality, speed and certainty in the securities markets. Id. at 22 n.10. See also Lowenschuss v. Resorts Int'l, Inc. (In re Resorts Int'l, Inc.), 181 F.3d 505, 514-16 (3d Cir. 1999) (payments to shareholders in LBO are settlement payments for purposes of Code § 546(e); funds transferred to shareholder who had tendered shares as part of merger but who had also demanded appraisal could not be recovered as fraudulent transfer; although no clearing agency was involved, wiring of funds from debtor to Chase Manhattan Bank, which forwarded the funds to Merrill Lynch, which in turn paid shareholder, satisfied requirement of Code § 546(e) that settlement payment be made by "financial institution"), cert. denied, 528 U.S. 1021 (1999); In re Hechinger Inv. Co. of Del., 274 B.R. 71, 86-88, 95-98 (D. Del. 2002) (applying In re Resorts Int'l; held, disbursing agent in LBO qualified as "financial institution" under Code § 546(e), and payments made to disbursing agent were thus unavoidable as fraudulent transfers; Code § 546(e) also pre-empted unjust enrichment claim against

[8] Financial participants were added to Code § 546(e) pursuant to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, enacted April 20, 2005. See Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 8, § 907(o)(3), 119 Stat. 23 (2005). The amendment applies to bankruptcy cases filed on or after October 17, 2005.

shareholders, officers, and directors for proceeds received from LBO because unjust enrichment effectively acts as avoidance claim).

iii) Other courts, however, have declined to extend Code § 546(e) protection to certain LBO transactions. See, e.g., Wieboldt Stores, Inc. v. Schottenstein, 131 B.R. 655, 663-65 (N.D. Ill. 1991) (Code § 546(e) did not prevent recovery from selling shareholders because Congress intended only to protect brokers and clearing agencies); Munford v. Valuation Research Corp. (In re Munford), 98 F.3d 604, 610 (11th Cir. 1996), cert. denied sub nom. DFA Dimension Grp. v. Munford, Inc., 522 U.S. 1068 (1998) ("regardless of whether the payments [to shareholders] qualify as settlement payments, Code § 546(e) is not applicable since the LBO transaction did not involve a transfer to one of the listed protected entities"); Jewel Recovery, L.P. v. Gordon, 196 B.R. 348, 353 (N.D. Tex. 1996) (held, Code § 546(e) did not protect selling shareholders from avoidance of LBO as fraudulent transfer because transaction was a private stock purchase; Code § 546(e) "appl[ies] to settlement payments in the clearance and settlement process in the public market" (emphasis added)); Zahn v. Yucaipa Capital Fund, 218 B.R. 656, 675 (D.R.I. 1998) ("The § 546(e) exception applies if the transfers were: (1) 'settlement payments'; and (2) made 'by or to' one of the enumerated entities"; section 546(e) exception inapplicable because transfer of non-publicly traded securities was not a "settlement payment," and even if transfers were settlement payments, they were not made by one of entities named in statute); Brandt v. Hicks, Muse & Co., Inc. (In re Healthco Int'l, Inc.), 195 B.R. 971, 981-83 (Bankr. D. Mass. 1996) (declining to apply Code § 546(e) to LBO because transfers were from debtor to selling shareholders, neither of which was stockbroker, financial institution, or securities clearing agency; "section 546(e) would not govern even if [stockbroker, financial institution, or securities clearing agency] acted as an intermediary"); In re Grand Eagle Cos., Inc., 288 B.R. 484, 493-95 (Bankr. N.D. Ohio 2003) (creditors' committee challenged LBO involving purchase of privately held stock as fraudulent transfer; held, Code § 546(e) did not preclude challenge); In re OODC, LLC, 321 B.R. 128, 144-45 (Bankr. D. Del. 2005) (held, Code § 546(e) inapplicable to LBO because transaction was asset sale, not stock sale, and payments were made to shareholders through selling companies, not through commodity broker, forward contract merchant, stockbroker, financial institution, or securities clearing agency; "Consequently, the instant case does not implicate the settlement and clearing systems for stock sales in any way").

VI. Right to a Jury Trial

Historically, parties assumed that there was no right to a jury trial in a fraudulent transfer suit because the relief sought was supposedly equitable in nature. The Supreme Court of the United States, in Granfinanciera, S.A. v. Nordberg, 492 U.S. 33 (1989), rejected this view, however, holding that the Seventh Amendment entitles a person, who has not submitted a claim against a debtor's estate, to a jury trial in a fraudulent transfer suit. When a bankruptcy trustee alleges an actual or constructively fraudulent transfer of monies, the defendant cannot be denied its Seventh Amendment right to a trial by jury so long as the defendant has not submitted a claim against the debtor's estate, the premise being that filing a claim constitutes a submission to the court's jurisdiction). Langenkamp v. Culp, 498 U.S. 42 (1990) (preference defendant who filed claim against bankruptcy estate not entitled to jury trial under Seventh Amendment because by filing such claim, defendant subjected himself to bankruptcy court's equitable power and triggered claims-allowance process that is triable only in equity.)

The right to a jury trial exists despite the statutory designation of fraudulent transfer actions as "core proceedings," triable by a bankruptcy judge sitting without a jury. 28 U.S.C. § 157(b)(2)(H). According to the Supreme Court, although Congress may assign jurisdiction over claims asserting a "public" right, Congress lacks the power to strip parties asserting "private" rights of their constitutional right to a jury trial. Granfinanciera, 492 U.S. 51-52. Reasoning that fraudulent transfer suits are "quintessentially suits at common law that more nearly resemble state-law contract claims brought by a [debtor] corporation to augment the bankruptcy estate than they do creditors' hierarchically ordered claims to a pro rata share of the bankruptcy res," the Court concluded that a bankruptcy trustee's right to recover a fraudulent transfer is more accurately characterized as a private rather than a public right. Id. at 56.

The Tenth Circuit extended the reach of Granfinanciera to require jury trials in fraudulent transfer actions even if the defendant had filed a proof of claim. Kaiser Steel Corp. v. Frates (In re Kaiser Steel Corp.), 911 F.2d 380 (10th Cir. 1990). According to the court, fraudulent transfer suits were plenary, and did not arise "'as part of the process of allowance and disallowance of claims.'" (internal cites omitted) Id. at 389. Shortly thereafter, however, the Supreme Court reiterated its ruling that defendants who had filed proofs of claim were *not* entitled to a jury trial in a preference action, rejecting the "plenary" reasoning of the Tenth Circuit in Kaiser. Langenkamp v. Culp, 498 U.S. 42, 44 (1990) ("If [after filing a proof of claim] the creditor is met, in turn, with a preference action . . . that action becomes part of the claims-allowance process which is triable only in equity."). See also Official Committee of Unsecured Creditors v. Schwartzman (In re Stansbury Poplar Place, Inc.), 13 F.3d 122 (4th Cir. 1993) (holding that filing a proof of claim against one debtor in a jointly administered case did not waive the claimant's right to a jury trial in an action brought by another of the jointly administered debtors); Citicorp N. Am., Inc. v. Finley (In re Washington Mfg.), 133 B.R. 113, 117 (M.D. Tenn. 1991) (rejecting trustee's demand for jury trial on fraudulent transfer claim because defendant had filed proof of claim and avoidance action thereby became "equivalent to an objection to the creditor's claim"); In re Hechinger Inv. Co. of Del., 327 B.R. 537, 545-46 (D.Del 2005) (held, fraudulent transfer action against pre-petition lenders not entitled to jury trial because "plaintiff's … suit mirrors…objection to the [lenders'] claims. Consequently, …claims are part of the process of allowance and disallowance of claims …"). As a result, a creditor may be forced to choose between filing a timely proof of claim and preserving its right to a jury trial in a preference and fraudulent transfer action. First Fidelity Bank v. Hooker Invs. (In re Hooker Invs.), 937 F.2d 833 (2d Cir. 1991) (affirming lower courts' rulings that when bar date falls during pendency of adversary proceeding against creditor, creditor must choose between filing a proof of claim and preserving its right to a jury trial because "[i]f individual creditors were permitted to postpone indefinitely the effect of a bar order so long as adversary proceedings were pending, the institutional means of ensuring the sound administration of the bankruptcy estate would be undermined."). See also Stainer v. Latimer (In re Latimer), 918 F.2d 136 (10th Cir. 1990), cert. denied, 502 U.S. 863 (1991) (defendants must request a jury trial and a transfer to district court; failure to request both results in waiver of right to jury trial); Committee of Unsecured Creditors v. 90th Street Garage Corp. (In re Term Industries, Inc.), 181 B.R. 31 (Bankr. S.D.N.Y. 1995), appeal dismissed as moot, No. 95-4658, 1995 WL 758608 (S.D.N.Y. Dec. 22, 1995) (action for avoidance of transfer and turnover of stock certificates transferred to affiliate was equitable action carrying no right to jury trial under Granfinanciera; alternatively, by asserting its own release in confirmed plan as defense, affiliate submitted itself to bankruptcy court's equitable jurisdiction and waived right to jury trial).

In Granfinanciera, the Supreme Court specifically left open the question of whether bankruptcy courts may conduct jury trials in core proceedings. Granfinanciera, 492 U.S. at 59. The Supreme Court later declined to resolve a split in the circuit courts on this issue. The Second Circuit has held that jury trials in core proceedings may be conducted by bankruptcy judges. Ben Cooper, Inc. v. Insurance Co. of Pa. (In re Ben Cooper, Inc.), 896 F.2d 1394 (2d Cir. 1990), vacated on jurisdictional grounds, 498 U.S. 964 (1990), reinstated, 924 F.2d 36 (2d Cir. 1991), cert. denied, 500 U.S. 928 (1991). According to the court, construing the Bankruptcy Code to allow jury trials in core proceedings is the only way to reconcile the requirements of the Seventh Amendment with Congress' intent in 28 U.S.C. § 157(b) to allow bankruptcy judges to conduct trials and issue final orders in core proceedings. Id. at 1402. More important, the court found no statutory or constitutional bars to a jury trial in the bankruptcy court. The court found that 28 U.S.C. § 1411, which preserves the right to a jury trial for personal injury and wrongful death tort claims, provided no guidance on the issue.

The Second Circuit further held that the Seventh Amendment's prohibition of reviewing jury findings other than in accordance with the common law would not be violated by conducting jury trials in core proceedings in the bankruptcy court because a district court's review of core proceedings is analogous to ordinary appellate review. Id. at 1403. The court also held that Article III of the Constitution would not be violated by jury trials in the bankruptcy court. Assuming that bankruptcy judges could enter final judgments in core proceedings without violating Article III, the court reasoned that jurors, who are less likely to be influenced by pressure from the executive and legislative branches, could also reach verdicts without violating Article III. Id. at 1403. The court assumed, without deciding, that 28 U.S.C. § 157(b) was constitutional.

Rejecting the Second Circuit's decision in Ben Cooper, the Eighth Circuit became the first of five circuit courts to hold that bankruptcy judges may not conduct and preside over jury trials in core proceedings. In re United Missouri Bank of Kansas City, 901 F.2d 1449 (8th Cir. 1990). The court reviewed the history of federal bankruptcy law, and emphasized that the broad grant of authority in the Bankruptcy Reform Act of 1978, by which Congress probably intended to give bankruptcy judges the authority to conduct jury trials, was held unconstitutional in Northern Pipeline Constr. Co. v. Marathon Pipeline Co., 458 U.S. 50 (1982). The court held that the authority of bankruptcy judges is vested by Congress, and that absent a grant of express or implied authority, a bankruptcy judge may not conduct jury trials. In re United Missouri Bank of Kansas City, 901 F.2d at 1453, 1454. The court held that 28 U.S.C. § 157(b) did not give bankruptcy judges express authority to conduct jury trials. Id. at 1454. For authority to be implied, it must be "'practically indispensable and essential in order to execute the power actually conferred.'" (citation omitted). Id. at 1456. The court found that the power to conduct jury trials was not necessary to carry out a bankruptcy judge's function to "'hear and determine'" and "'enter appropriate orders and judgments'" in core proceedings. Id. Because the court based its decision on a statutory analysis, it did not reach the constitutional issues. Id. at 1457. Accord Rafoth v. Nat'l Union Fire Ins. Co. (In re Baker & Getty Fin. Servs., Inc.), 954 F.2d 1169 (6th Cir. 1992).

The Tenth Circuit has also held that a bankruptcy judge may not conduct jury trials in core proceedings. Kaiser Steel Corp. v. Frates (In re Kaiser Steel Corp.), 911 F.2d 380 (10th Cir. 1990). The court specifically adopted the reasoning of the Eighth Circuit in United Missouri Bank. In particular, the court stressed the repeal of 28 U.S.C. § 1481, which gave bankruptcy

judges "the powers of a court of equity, law and admiralty," and the absence of any comparable provision in the 1984 Act. The Seventh Circuit followed the Tenth Circuit and held that a bankruptcy court cannot conduct a jury trial in a core proceeding because of the lack of statutory authority or bankruptcy rule permitting the bankruptcy court to do so. In re Grabill Corp., 967 F.2d 1152 (7th Cir. 1992), reh'g denied, 976 F.2d 1126 (7th Cir. 1992). Accord Official Committee of Unsecured Creditors v. Schwartzman (In re Stansbury Poplar Place, Inc.), 13 F.3d 122 (4th Cir. 1993). The Supreme Court granted a writ of certiorari in the Ben Cooper case to resolve the conflict among the circuits. Insurance Co. of Pa. v. Ben Cooper, Inc., 497 U.S. 1023 (1990). Without reaching the merits, however, the Court vacated the judgment and remanded on jurisdictional grounds. Insurance Co. of Pa. v. Ben Cooper, Inc., 498 U.S. 964 (1990). On remand, the Second Circuit held that it had proper jurisdiction, and reinstated its prior judgment; the Supreme Court subsequently denied a writ of certiorari. Ben Cooper, Inc. v. Insurance Co. of Pa., 924 F.2d 36 (2d Cir. 1991), cert. denied, 500 U.S. 928 (1991).

The Bankruptcy Reform Act of 1994, Pub. L. 103-394, 108 Stat. 4106, effective October 22, 1994, permits jury trials in the bankruptcy court if the parties expressly consent and the district court specifically designates the "exercise of such jurisdiction," assuming that there is a "right to a jury trial" in the particular dispute. H.R. 5116, § 112, 103 Cong. 2d Sess., Cong. Rec. H10755 (daily ed. Oct. 4, 1994) (amending 28 U.S.C. § 157(e)). In view of these obstacles, jury trials in the bankruptcy court will, as a practical matter, be rare.

VII. Core v. Non-Core Proceeding

Under 28 U.S.C. § 157(b)(2)(H), added by the Bankruptcy Amendments Act of 1984, proceedings to determine, avoid, or recover fraudulent transfers are "core proceedings" that may be heard and determined by bankruptcy judges, subject to appeal under 28 U.S.C. § 158. Teitelbaum v. Parameswaran (In re Parameswaran), 50 B.R. 780 (S.D.N.Y. 1985) (court has jurisdiction over action to set aside fraudulent transfer, pursuant to 28 U.S.C. § 157(b)(2)(H)); Blake v. Evans (In re Canion), 196 F.3d 579, 583 (5th Cir. 1999) ("fraudulent [transfer claims] are 'core' claims, 28 U.S.C. § 157(b)(2)(H) . . ."). Fraudulent transfer suits that are based entirely on state law, made applicable under section 544(b) of the Code, are still "core proceedings" properly tried in the bankruptcy courts. Duck v. Munn (In re Mankin), 823 F.2d 1296 (9th Cir. 1987), cert. denied, 485 U.S. 1006 (1988).