HOW TO AVOID INSIDER "SWEATHEART DEALS" BY AN INSOLVENT COMPANY

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CONSTRUCTIVE FRAUDULENT TRANSFERS TO RELATIVES OR FRIENDS OF OWNERS OF SMALL BUSINESSES WHO FACE BANKRUPTCY COMMONLY OCCUR,AND, IF LEFT UNDETECTED, CAN LEAVE LEGITIMATE CREDITORS WITH LITTLE OR NO RECOVERY FROM THE DEBTOR.

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Constructive Fraudulent Transfers Are Used By Unscrupulous Insolvent Companies To Favor Insiders At The Expense Legitimate Creditors

Constructive fraudulent transfers often are used by small family businesses as a means to give "sweetheart deals" to other family members or friends in anticipation of the company going bankrupt. Simply put, a constructive fraudulent transfer is a transfer of a debtor's property where the debtor did not receive reasonably equivalent value for the property transferred, and at the time of transfer, he was either insolvent, became insolvent as a result of the transfer, was undercapitalized, or he/she/it intended or believed that the company would be unable to pay its debts as they became due.

To protect creditors from this type of abuse, the bankruptcy code provides that certain transactions that occurred prior to the filing of the petition can be avoided as "constructive fraudulent transfers." 11 U.S.C. § 548. California also has enacted a fraudulent transfer statute based on the Uniform Fraudulent Transfer Act ("UFTA"). Cal. Civ. Code § 3439.01 *et seq*. The two statutes "are similar in form and substance" and the Ninth Circuit has held that they may be interpreted "contemporaneously." *Gill v. Maddalena (In re Maddalena)*, 176 B. R. 551 (Bankr. C.D. Cal. 1995) (citing *Wyle v. C.H. Rider & Family, et al. (In re United Energy Corp.)*, 944 F.2d 589, 594 (9th Cir. 1991).

There are, however, two primary differences between California law and the Bankruptcy Code.

The first is the need for a pre-transaction creditor in certain cases. Under Cal. Civ. Code § 3439.04 any creditor, pre-transaction or post-transaction, has standing to avoid a fraudulent transfer if the claim rests on unreasonably small capital or inability to pay debts as they become due. If, however, the transfer is considered fraudulent because the debtor was insolvent at the time or became insolvent as a result, there must be a pre-transaction creditor in order to have standing to avoid the transfer.

To avoid a transfer under 11 U.S.C. § 548, the trustee must show two things. First, he must show that the debtor did not receive reasonably equivalent value. Value is defined for purposes of § 548 of the Code as "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." 11 U.S.C. § 548(d)(2)(A).

Once the trustee has established that the debtor did not receive reasonably equivalent value in the transaction, he must prove one of three things: 1) the debtor "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;" 2) 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;" or 3) the debtor "intended to incur, or believed that [he] would incur, debts that would be beyond [his] ability to pay as such debts matured." 11 U.S.C. § 548(a)(1)(B)(ii)(I), (II), and (III).

The second difference is the statute of limitations. Fraudulent transfers occurring within two years of the filing of the petition are avoidable under the bankruptcy code. Under California Civil Code §3439.09, the statute of limitations is four years. Section 544 of the bankruptcy code allows a trustee (or debtor in possession) to use the state cause of action to capture transfers that are fraudulent "under applicable law." Thus, the state action is frequently used to avoid transfers dating back farther than two years. 11 U.S.C. § 544(b)(1)("[T]he trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law. . . .); *see Gottlieb v. Boyadzhyan (In re Boyadzhyan)*, 2005 Bankr. Lexis 2117, at *10 (Bankr. C.D. Cal. 2001) ("Pursuant to 11 U.S.C. § 544(b), the trustee may avoid any transfer of an interest of the debtor in property that is voidable under applicable law. . . . California fraudulent transfer law is applicable.").

Accordingly, debtors who can point to "sweetheart deals" as long ago as four years before the company went bankrupt may be able to unwind the deal and obtain more money to pay the debts owed by the debtor.

It Is Not Always An Easy Task, However, To Determine Whether The Debtor Was Insolvent When The "Sweetheart Deal" Was Done.

The Bankruptcy Code defines insolvency as "a financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation . . . ." 11 U.S.C § 101(32)(A). This test is more commonly referred to as a "balance sheet test".

However, "the debtor's balance sheet is only the starting point." Robert Stearn, Proving Solvency: Defending Preference and Fraudulent Transfer Litigation, The Business Lawyer, February 2007 [hereinafter, "Stearn"]. As the court has discretion to review the assets and liabilities to ensure they are accurately reflecting their going concern value. Certain items on a balance sheet may be omitted from the court's valuation inquiry, most commonly goodwill and contingent assets or liabilities. *Id.* at 362. *See also In re Bay Plastics*, 187 B. R. at 315 ("Goodwill must be disregarded in a determination of solvency, even though it was calculated consistent with generally accepted accounting principles, because you cannot sell it to satisfy the creditors' claims."). The UFTA (which California has adopted and is codified as Cal. Civ. Code §3439 et seq.) uses both the balance sheet test and the "equity" or "cash flow" test. The equity test presumes the debtor insolvent if he is generally not paying his debts as they become due. *In re Bay Plastics, Inc*., 187 B. R. at n. 22.

Most solvency determinations are comprised of a two-part inquiry. First, the court must decide the appropriate premise of value. That is, whether to assess the debtor's assets as a "going-concern" (fair market value) or a liquidation (forced sale) situation. Stearn, at 367. The key to this decision is the state of the debtor at the time of the transaction. Obviously, assessing the assets as a going-concern is considerably more beneficial to defendants in avoidance proceedings because proving solvency is more likely. Additionally, when valued as a going concern, "it is assumed that the debtor is sold as a mass assemblage of income producing assets, which would include the value of the synergistic relationship among the debtor's tangible and intangible assets." Id. at 368. In contrast, under a liquidation valuation, the assets are assessed as though they were sold "piecemeal and without a normal level of exposure to the market." Id. at 369.

Courts generally presume that going-concern is the appropriate premise of value. Liquidation premise only applies when "the debtor was in a precarious financial condition, on its deathbed and/or only nominally in existence." *Id.* at 370. *See American Classic Voyages Co. v. J.P. Morgan Chase Bank (In re American Classic Voyages Co.)*, 2007 WL 1237828, at *6 (Bankr. D. Del. 2007) ("If liquidation in bankruptcy was not 'clearly imminent' on the transfer date, then the entity should be valued as a going concern."); *see also Heilig-Myers Co. v. Wachovia Bank (In re Heilig Meyers Co.)*, 328 B.R. 471, 487-488 (E.D. Va 2005)("The going concern threshold is very low; a debtor may be financially unstable, but it is still a going concern as long as the amount it could realize from converting its assets to cash in the ordinary course of business exceeds the expenses of conducting business.").

The date of valuation is the date of the contested transaction. Valuation as of the pertinent date can only take into consideration information that was known or reasonably available at the time, "hindsight should not be used to determine the debtor's status on the transfer date." Stearn, at 372. Post-petition asset sales should not be used as evidence of value when the entity is being assessed under a going concern premise. Id. at 375. *See In re Heilig*, 328 B.R. at 481,483 ("[T]he consistent approach is for the court to reject any value that takes into account post-petition events as one would expect when valuing the assets of a going concern. . . . Reliance on post-petition effects on the value of the debtors' assets and liabilities would run contrary to the legal precepts applicable to a going concern analysis."). However, under a liquidation premise standard, courts have frequently ignored the valuation date requirement and assessed the debtor's assets based on post-bankruptcy asset sales. Stearn, at 378.

The Parties Often Will Dispute Whether "Reasonably Equivalent Value" Was Provided.

The determination of reasonably equivalent value is a factual inquiry with ample discretion afforded to the trier of fact. Pajaro Dunes Rental Agency, Inc. v. Spitters (In re Pajaro Dunes Rental Agency, Inc.), 174 B.R. 557, 578 (N.D. Cal. 1994)("[W]hether fair consideration has been given for a transfer is largely a question of fact, as to which considerable latitude must be allowed to the trier of facts."). Typically, courts will employ a totality of the circumstances test. Alan Resnick, et al. COLLIER ON BANKRUPTCY-15th ed. Rev. § 548.05 (2007)(hereinafter "COLLIER"). Despite the breadth of the legal test, there are a few governing principles.

First, the determination of value must be made as of the date of transfer. *In re Maddalena*, 176 B. R. at 555 (citing *In re Morris Communications NC, Inc*., 914 F.2d 458, 466 (4th Cir. 1990)). "Subsequent appreciation or depreciation should not, and does not, transform a transfer for reasonably equivalent value into a fraudulent transfer." *Krommenhoek v. Natural Resources Recovery, Inc. (In re Treasure Valley Opportunities)*, 166 B.R. 701, 704 (Bankr. D. Idaho 1994)(citing COLLIER, at 548-116).

The purpose of the trustee's ability to avoid certain transactions is to allow for the preservation of the debtor's estate for the benefit of his creditors. *In re Pajaro Dunes*, 174 B.R. at 571. Because of this, reasonably equivalent value must be determined from the standpoint of the creditors. *Bay Plastics, Inc. v. BT Commercial Corp. (In re Bay Plastics, Inc.)*, 187 B. R. 315, 328 (Bankr. C.D. Cal. 1995). "Reasonably equivalent value 'is to be judged from the standpoint of the creditors of the debtor.'" *Nasr v. Geary*, 2003 U.S. Dist. LEXIS 13887, at *62-63 (C.D. Cal. 2003) (quoting 1986 legislative committee comment for Cal. Civ. Code § 3439.03).

"In determining whether a debtor received reasonably equivalent value for a transfer, a court compares the value of the property transferred with the value of what the debtor received in exchange for the transfer." *Nasr*, 2003 U.S. Dist. LEXIS 13887, at

*62-63; *see also In re Pajaro Dunes*, 174 B.R. at 578 ("Whether [the debtor] received reasonably equivalent consideration is determined from the perspective of the creditors of the estate. . . . The analysis is directed at comparing what the debtor surrendered and what the debtor received."); *In re United Energy Corp*., 944 F.2d at 597 (same).

There are some cases in which the contested transfer was clearly an exchange of reasonably equivalent value. In *Barisich v. Lewis*, 226 Cal. App. 3d 12, 20 (1990), a third party received reasonably equivalent value for interest in property that was transferred to the plaintiff because the third party owed plaintiff $ 21,000 and a comparable interest in property had been sold for $ 20,000. Similarly, reasonably equivalent value was clear in *In re Treasure Valley Opportunities*. There, the Debtor and defendant had entered into a contract for the building of wood pellet production plant. When debtor filed a petition under Chapter 7, the trustee attempted to avoid the payments made by Debtor on the contract. Where all parties conceded that completion of the contract would result in the building of a plant worth the amount paid by debtor, reasonably equivalent value was exchanged as to all payments made on the contract. "Each payment toward the contract was the purchase of an interest in the contract equal to the amount of the payment." 166 B.R. at 704; *see also Frontier Bank v. Brown (In re Northern Merchandise, Inc.)*, 371 F.3d 1056, 1059 (9th Cir. 2004)(Debtor did receive reasonably equivalent value where bank gave debtor a loan and took a security interest in his assets for the same amount).

For other transactions, the lack of reasonably equivalent value is relatively clear. This is particularly true where it is clear that the debtor received little or nothing of value in exchange for something forfeited. For example, in a leveraged buy-out, the purchasers financed the deal by taking a $3.95 million loan out, securing it with nearly all of the corporation's assets. They paid $3.5 million to the selling shareholders. The remaining $450,000 was determined insufficient to meet the test of reasonably equivalent value considering the obligation the company undertook in leveraging all of its assets. In re Bay Plastics, 187 B. R. at 330. In another case, the debtor did not receive reasonably equivalent value where he forfeited 40% ownership interest in assets and received nothing in return. *United States Fid. & Guar. Co. v. Scott Cos*., 2007 U.S. Dist. Lexis 34847 (N.D. Cal. 2007).

In more complex scenarios, the court must first make a determination of the value of the assets transferred or received. Where this is necessary, courts largely rely on expert testimony. Where both parties have presented an expert, courts must make a credibility determination. *In re Pajaro Dunes*, 174 B.R. at 587("On the basis of the evidence before the Court, the Court finds that Sugarman was the more credible of the two experts on the stand with respect to the value of this particular investment, . . . Sugarman was better prepared, and had answers to the questions most crucial to the valuation of the building.") ; *see also In re Maddalena*, 176 B. R. at 554 (In reaching a conclusion about the value of the note at issue, the court relied on "the testimony of Mr. Kapko, the witness offered by Plaintiff, whose presentation the Court found to be thorough and competent, and superior to the expert testimony sponsored by Defendant.").

The totality of the circumstances test also includes consideration of external factors. The nature of the transaction can weigh in favor or against a finding of reasonably equivalent value. Evidence that the transaction was conducted at arms length, negotiated and subject to external valuation methods weighs in favor of a finding of equivalent value. A California court relied in part on evidence of this type, finding that the transfer should not be avoided, the court noted the strong evidence that the transfer was in fact "a fair transaction as a result of arms length negotiations between the seller . . . and the purchaser . . . at a time when other potential purchasers were also interested in the company." *Credit Managers Ass'n of Southern California v. The Federal Company*, 629 F. Supp. 175, 188 (C.D. Cal. 1985); *see also In re Pajaro Dunes*, 174 B.R. at 588 (Weighing against reasonably equivalent value was the fact that the "lease was not negotiated at arms length.")(emphasis added). Another California court relied on evidence that in selling their home, the debtors "had no incentive to negotiate . . . for a higher price. Their intent was to 'fire-sale' the Property within forty days." *Salven v. Munday (In re Kemmer),* 265 B.R. 224, 232 (Bankr. E.D. Cal. 2001). The Debtors' financial situation dictated that they could not wait until optimal selling season, nor could they spend any amount of time or money in minimal upgrades to ready the property for the market. Id. The Court held that 'reasonably equivalent value' implies that the transfer process itself must be 'reasonable' and consistent with normal marketing practices. Id. at 233. On this evidence, the court held that the "sale was not conducted at arms length and that the Kemmers did not receive reasonably equivalent value for the Property." *Id*. at 234.

Even If The Debtor Was Solvent When It Made The "Sweatheart Deal," The Deal Still Can Be Undone If It Left The Debtor With Insufficient Capital To Pay Its Debts As They Came Due.

Even where the company is solvent at the time of the transfer, the transfer is still subject to avoidance if the debtor did not receive reasonably equivalent value and the company "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." 11 U.S.C. § 548(a)(1)(B)(ii)(II).

Unreasonably small capital "refers to the inability to generate sufficient profits to sustain operations." Stearn, at 385 (citation omitted); *see also Nasr*, 2003 U.S. Dist. Lexis 13887, at *64 ("Unreasonably small assets signify an inability to generate enough cash flow from operations and the sale of assets to remain financially stable.").

In assessing unreasonably small capital, courts look at cash flow, projections, and other forward-looking factors. The critical question is 'reasonable forseeability,' whether or not the projections for income were reasonable or did they expose the creditors to an unreasonable risk of default. Stearn, at 389. In this context, "'[r]easonableness' is often measured through the use of cash flow projections and other forward-looking sources of evidence available to the debtor and its creditors at the time of the transfer. If these sources were flawed and overly optimistic from the beginning, then they were unreasonable." *In re Pajaro Dunes*, 174 B.R. at 593.

"Evaluation of cash flow projections must focus on information available at the time of the transaction, not on hindsight." *Nasr*, 2003 U.S. Dist. Lexis 13887, at *64. The court in Nasr further explains that the inquiry is aimed at assessing, "whether the amount of all the assets retained by a debtor was inadequate, i.e., unreasonably small in light of the needs of the business or transaction in which the debtor was engaged or about to engage." Id. "[B]ecause inability to generate cash flow must precede an inability to pay obligations as they become due, unreasonably small capital would seem to encompass financial difficulties short of equitable insolvency. . . . [it] means just barely equitably solvent." Lee Shepard, Beyond Moody: A re-Examination of Unreasonably Small Capital, 57 Hastings L.J. 891, 907 (2006) (hereinafter "Shepard"). The test is aimed at transferees that leave the transferor technically solvent, but doomed to fail. *MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Servs. Co. (In re MFS/Sun Life Trust)*, 910 F. Supp. 913, 944 (S.D.N.Y. 1995).

When analyzing "cash flow" courts have looked at a number of potential sources of income including, cash from operations, proceeds from debt financing, equity financing, and asset sales. *See Peltz*, 279 B.R. at 744-745 (Finding that an analysis of adequacy of capital should take into account "all reasonably anticipated sources of operating funds, which may include new equity infusions, cash from operations, or cash from secured or unsecured loans over the relevant time period."). The Peltz court also recognized that if a company anticipated inadequate capital, they could have scaled back operations to compensate. Id. Failing to do so weighs against a finding of unreasonably small capital. Similarly, expending substantial amounts of cash to fund expansion weighs against a finding of unreasonably small capital. *Fid. Bond & Mortg. Co. V. Brand (In re Fid. Bond & Mortg. Co.)*, 340 B.R. 266, 300 (Bankr. E.D. Pa. 2006). Other courts have held that the ability to secure additional funding can be evidence of adequate capital. *Daley v. Chang (In re Joy Tech. Corp.)*, 238 B.R. 54, 76 (Bankr. N.D. Ill. 2002) (In finding that Debtor had adequate capital, the court relied in part on the fact that the Debtor "had a $1.5 million credit line at Pioneer after the close of the LBO, and the Trustee did not refute the fact that the company had additional borrowing capacity."); *see Moody v. Security Pacific Business Credit*, 971 F.2d 1056, 1072-73 (3rd Cir. 1992) (holding the debtors' ability to secure funding a proper consideration under the capitalization test)

The first case in California to undertake a detailed analysis of undercapitalization was *Credit Managers Ass'n of Southern California v. The Federal Company*, 629 F. Supp. 175, 184 (C.D. Cal. 1985). To determine whether or not the debtor was undercapitalized, the court looked to the debtor's projected sales, gross profit margins, inventory turnover, accounts receivable collection period and their balance sheet. *Id*. at 184-188. In particular, with the balance sheet analysis, the court, relying on expert testimony, found a number of the debtor's assets undervalued on the books. *Id*. at 187. Despite being in debt, the court determined that the debtor "was a viable entity with sufficient capital to generate income to cover the debt service and make a profit." *Id*. at 184.

Some courts have held that the time period is particularly relevant here. "[C]ourts have held that companies do not have unreasonably small capital if they survive for an 'extended period' of time—up to one year." Shepard, at 910 (citing *Moody*, 971 F.2d at 1074 (no unreasonably low capital where creditors paid for twelve months after transaction)). While the specific allowable time period varies by jurisdiction, many courts have found that lasting for a certain period of time after the transaction renders the debtor necessarily capitalized at the time of transfer. A New York court held, "the adequacy of capital need only be tested within a reasonable period of the transfer at issue." *In re MFS/Sun Life Trust*, 910 F. Supp. at 944. In *In re MFS/Sun Life Trust* the company was viable for eight months after a leveraged buyout. The court there found that "the company remain[ing] viable so long after the LBO strongly suggests that its ultimate failure cannot be attributed to inadequacy of capital as of the date of buyout." *Id.; In re Fid. Bond & Mortg.* Co., 340 B.R. at 299 ("Another factor to consider in an unreasonably small assets test is the length of time a company continued to operate and pay creditors after a disputed transfer.").

Creditors Of Small Businesses, Especially Family-Owned Businesses, Should Explore Whether Insider "Sweetheart Deals" Were Made Before The Business Went Bankrupt.

Give the prevalence of constructive fraudulent transfers in bankruptcies involving small, family owned businesses, creditors should explore whether such "sweetheart deals" were made. If so, unwinding such deals may present the only realistic hope of recovering any appreciable portion of the debts owed.