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Mitigating Lender Risk

In Constructive Fraudulent Transfer Litigation

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SHUTTERSTOCK

The constructive fraudulent transfer provisions of the Bankruptcy Code (§548(a)(1)(B)) and state law (made applicable in bankruptcy cases under Bankruptcy Code §544(b)) give the bankruptcy estate representative (e.g., a Chapter 11 trustee, debtor-in-possession or creditors' committee (through derivative standing, discussed below)) the right to avoid a transfer of an interest of the debtor in property, or any obligation incurred by the debtor if the debtor, among other things: (1) received less than reasonably equivalent value in exchange for such transfer or obligation incurred; and (2) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result thereof. Generally, "less than reasonable equivalent value" means less than fair consideration (there is a range of value of what would be considered fair consideration), and "insolvency" means the debtor had liabilities (including appropriately valued contingent liabilities) in excess of the fair market value of its assets.

Lenders to a debtor sometimes view constructive fraudulent transfer claims against equity holders and other non-lender third parties as an estate asset that may boost their recovery. Proceeds from these claims are often shared pari passu with the general unsecured creditors, which in certain cases will include under-secured creditors on account of the portion of their total claim that is not secured by collateral (i.e., the "deficiency claim").

However, a lender may also be the target of constructive fraudulent transfer claims if: (1) the borrower and/or guarantor obligor was insolvent at the time of the loan transaction or was rendered insolvent upon consummation thereof; and (2) the obligor did not receive "reasonably equivalent value" because it did not obtain a benefit from the loan. If a

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loan transaction is avoided as a constructive fraudulent transfer: (1) the lender's claim against the obligor in bankruptcy may be disallowed or subordinated; and (2) the lender may also have to disgorge any debt service payments it received, plus prejudgment interest thereon.

Collapsing a Multi-Staged Lending Transaction

Although there is no provision in the Bankruptcy Code or binding Supreme Court case law so stating, many courts, including the U.S. Courts of Appeals for the Second and Third Circuits, have held that multi-staged lending transactions, which are typically found in an LBO or dividend recapitalization, may be collapsed and treated as integrated phases of a single transaction for purposes of evaluating whether a transferor or obligor received reasonably equivalent value. See *HBE Leasing v. Frank*, 48 F.3d 623, 635 (2d Cir. 1995). The "paradigmatic scheme" justifying collapsing is where "one transferee gives fair value to the debtor in exchange for the debtor's property, and the debtor then gratuitously transfers the proceeds of the first exchange to a second transferee." As a result, the "first transferee receives the debtor's [repayment obligation], and the second transferee receives the consideration, while the debtor retains nothing." Where collapsing occurs, the lenders are viewed as having remitted the consideration directly to stockholders, with no corresponding value to the debtor. Prior to collapsing a multi-staged lending transaction, both the Second and Third Circuits require that the lender have knowledge of the multiple interdependent transactions—i.e., in an LBO, knowledge that the loan proceeds would be used to redeem the stock of the seller. See *HBE Leasing*, 48 F.3d at 635 (holding that the initial transferee "must have actual or constructive knowledge of the entire scheme that renders her exchange with the debtor fraudulent"); *In re Mervyn's Holdings*, 426 B.R. 488, 497 (Bankr. D. Del. 2010) (holding that the Third Circuit's decision in *United States v. Tabor Court Realty,* 803 F.2d 1288, 1302 (3d Cir. 1986) supports a three-pronged test concerning the propriety of collapsing multiple individual transfers when determining whether a transaction constitutes a fraudulent transfer: (1) "whether all of the parties involved had knowledge of the multiple transactions"; (2) "whether each transaction would have occurred on its own"; and (3) whether each transaction was dependent or conditioned on other transactions).

There is some ambiguity in the case law over what constitutes knowledge for purposes of collapsing the multistep loan transaction. At a minimum, knowledge means that the lender in a multi-step loan transaction such as an LBO or dividend recapitalization knows the various steps of the loan transaction and purpose and use of proceeds of the underlying loan—i.e., redemption of stock or payment of a dividend. To that end, virtually all syndicated loans will satisfy this requirement, as the use of loan proceeds will be disclosed in any confidential information memorandum circulated to prospective lenders, and the loan agreement itself will likely have a section outlining the use of proceeds.

Some case law suggests that in order to satisfy the "knowledge" prong of the collapsing doctrine, the plaintiff must also prove that the lender "knew or consciously avoided discovering that" the LBO or dividend that the lender was funding was a constructive fraudulent transfer "or that the Debtor was insolvent or that it would be rendered insolvent as a result of the acquisition." See *In re Sunbeam*, 284 B.R. 355, 372-73 (Bankr. S.D.N.Y. 2002). Such "knowledge" standard is harder to prove, as there is effectively a rebuttable presumption that a lender would not knowingly fund into an insolvent enterprise, with a potential clawback exposure. To state the obvious, defending against collapsing is one of the lender's primary lines of defense in fending off a constructive fraudulent transfer claim.

Since a large portion of syndicated loans are made to fund LBOs and dividend recapitalizations, a lender party to such transactions must be aware of the risk that its loan is subject to a fraudulent transfer challenge and strategically position itself to defend against that risk. Even a refinancing of an LBO loan has some risk to the new lenders, which should be accounted for when such loans are made. The fraudulent transfer argument made in this context is that refinancing a tainted fraudulent transfer loan does not provide a benefit to the debtor. The counter-argument is that the debtor actually received the proceeds of the refinancing and the real target should remain the original lender to the LBO or dividend recapitalization.

Derivative Standing

It is important that a lender understand the procedural considerations related to the prosecution of bankruptcy estate claims, including a constructive fraudulent transfer claim against a lender. Typically, the debtor-in-possession through its board of directors decides whether to prosecute or settle estate claims. In certain situations, the board may have been involved in the transactions at issue, in which case an independent director may be appointed for purposes of investigating such transaction. In this and other circumstances, many courts, including the Second Circuit in *Unsecured Creditors Comm. of Debtor STN Enters. v. Noyes (In re STN Enterprises)*, 779 F.2d 901 (2d Cir. 1985), have granted control over the prosecution and/or settlement of estate claims to creditor committees (i.e., obtain "derivative standing"). To obtain derivative standing, a creditors' committee must either: (1) file a motion with the bankruptcy court that (a) presents colorable claims for relief "that on appropriate proof would support a recovery" and (b) demonstrates that the "debtor unjustifiably failed to bring suit"; or (2) obtain it consensually from the debtor-in-possession.

A lender may be able to leverage its support for the creditors' committee's efforts to obtain derivative standing for certain estate claims in exchange for the creditors' committee's agreement to support the non-prosecution and release of constructive fraudulent transfer claims against such lender in connection with a plan of reorganization or separate settlement agreement. Other consideration commonly provided by a lender include: (1) "gifting" additional economic consideration to other creditors in connection with a plan of reorganization or other bankruptcy transactions; (2) stipulating or settling certain contested issues favorably to other creditors, such as valuation of collateral, intercompany claim reconciliation or the scope of unencumbered property; and (3) conceding points ancillary to creditor recoveries that are important to trade creditors and other stakeholders, such as assumption of executory contracts and less debt in the capital structure at emergence.

In addition, lenders must ensure that their diligence and communications (both internal and external) at the time of the loan substantiate the lender's belief that the borrower and any subsidiary guarantors are each solvent immediately after the loan was made. Lenders should also keep records of any such diligence and communications. Oftentimes, third party solvency opinions are made a condition precedent for the loan. In the case of guarantor-obligors, it is useful to document the direct and indirect benefits received by the guarantor in exchange for providing its guaranty.

It is also important to remember that constructive fraudulent transfer litigation is often brought years after the transfer were made. In such circumstance, it may be that economic events occurring after the loan is what caused the insolvency of the debtor. Lenders should document these unforeseen changes in the borrower's financial condition after the loan was made in order to bolster their defense to a constructive fraudulent transfer claim.

Moreover, where possible, the lender should structure the loan to avail itself of Bankruptcy Code §546(e), which bars a transfer from being avoided as a constructive fraudulent transfer if such transfer is made by a "financial institution" in connection with a "securities contract."

Conclusion

Finally, though constructive fraudulent transfer claims against pre-petition equity holders and D&Os may boost a lender's recovery either directly (through participation in any recovery) or indirectly (by distributing the recovery to other creditors for purposes of a consensual plan of reorganization), the same underlying facts and considerations that give rise to the constructive fraudulent transfer claims against others may also support loan avoidance. Accordingly, lenders must carefully analyze the full ramifications of how best to approach the constructive fraudulent transfer issue when it emerges in their bankruptcy case.