focus BANKRUPTCY

Fraudulent transfers in bankruptcy: A primer

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Fraudulent transfer laws originated in the 1500s with the Statute of Elizabeth, the goal being to protect creditors from unfair debtor transactions. Many states, including Michigan, have adopted the Uniform Fraudulent Transfer Act (MCL § 566.31-43) (UFTA).

The Bankruptcy Code also contains a fraudulent transfer statute (11 U.S.C. § 548). A trustee in bankruptcy is provided significant rights, including the ability to sue to recover fraudulent transfers under both applicable state law through 11 U.S.C. § 544 and the Bankruptcy Code.

The Bankruptcy Code and Michigan's UFTA each provides for two types of fraudulent transfer claims: actual and constructive.

Actual fraudulent transfers

Section 548 of the Bankruptcy Code provides for an actual fraudulent transfer claim:

"The trustee may avoid any transfer ... of an interest of the debtor in property, or any obligation ... incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily —

"(A) made such transfer or incurred such obligation with actual intent to hinder, delay or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted ..." 11 U.S.C. § 548(a)(1)(A).

Michigan's UFTA provides what courts recognize as a similar standard (MCL § 566.34). Both statutes are written in the disjunctive, such that a trustee need only show a debtor intended to hinder, delay, or defraud.

The intent to hinder, delay, or defraud must have existed at the time of the transfer. The Michigan UFTA provides that actual intent to hinder, delay, or defraud can be established by considering whether 11 enumerated badges of fraud occurred, such as the transfer being to an insider or being concealed.

When a transfer is avoided as fraudulent under the Bankruptcy Code, "the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, ..." 11 U.S.C. § 550(a).

Defenses to an actual fraudulent transfer claim

Michigan's UFTA and Bankruptcy Code § 548(c) provide a defense for transferees who took the property "for value and in good faith." The defense applies to the extent value was provided, which is broadly defined to include property or the satisfaction or securing of a present or antecedent debt (11 U.S.C. § 548(d)(2)(A)).

This section is rife with litigation because the legal standard for "good faith" is not clear. Courts examine the good faith defense on a case-by-case basis. Case law indicates that the primary question in analyzing a good faith defense is: "Would a reasonable person have been put on notice that the transferor may be insolvent or may have a fraudulent purpose when making the transfer?"

The inquiry is intensely factual. Courts have identified "red flags" indicating a transferee received inquiry notice that the transferor was insolvent or was engaged in fraudulent conduct. Case law further clarifies that a transferee cannot manufacture a good faith defense by willfully ignoring facts suggesting insolvency or a fraudulent purpose.

The transferee defendant bears the burden of proof in showing it is entitled to the protections of § 548(c). Therefore, the trustee is not required to plead a defendant transferor's bad faith or lack of good faith.

Constructive fraudulent transfers

The Bankruptcy Code and Michigan's UFTA also permit a plaintiff to bring a constructive fraudulent transfer claim. Transfers made, or obligations incurred, for less than a reasonably equivalent value are subject to avoidance if the debtor was or thereby became insolvent, was engaged in business with an unreasonably small capital, intended to incur debts that would be beyond his ability to repay, or made the transfer to an insider. No showing of fraudulent intent is necessary. (11 U.S.C. § 548(a)(1)(B)).

Reasonably equivalent value exists if the debtor receives a fair equivalent in exchange for its property or obligation. If not, the transfer or obligation will have depleted the debtor's assets. A constructively fraudulent transfer depletes the assets of an already insolvent debtor by the difference between the true value of the property and the amount the debtor actually received.

In the typical constructive fraudulent transfer case, the transferor is claimed to have received less than what the asset transferred was reasonably worth and, at the time of the transfer, to have been insolvent.

For example, let's say BrokeCo. transferred its pristine 2012 company car, for which it paid $30,000 within the year, to a third party for $5,000. The value was clearly not reasonably equivalent. However, to constitute a constructively fraudulent transfer, the insolvency element must also be established to demonstrate creditor harm. Creditors would be harmed only if there are insufficient assets remaining to pay their claims.

Creditors would arguably not be harmed if a solvent company transferred the car under similar circumstances. For example, if Google transferred a company car to a third party under the same facts, Google's creditors would not be harmed; vendors should still be paid in full because Google is flush with cash.

On the other hand, where BrokeCo.'s assets are insufficient to pay all creditors, every dollar BrokeCo. parts with could result in a creditor being paid a dollar less on its claim against BrokeCo.

Statute of Limitations

The look-back period for a fraudulent transfer claim under the Bankruptcy Code is two years before the date of the filing of the bankruptcy petition, such that a transfer made within those two years is subject to avoidance. Michigan's UFTA generally provides a six-year look-back period, which is why trustees often use state law through 11 U.S.C. § 544.

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