



# HOW TO Minimize THE RISK OF BANKRUPTCY AVOIDANCE ACTIONS

The Bankruptcy Code allows trustees to sometimes claw back borrowers' loan payments and avoid liens. Rock-solid procedures will help keep you from being sued for preferential transfers and constructively fraudulent conveyances.

## BY MICHAEL D. FIELDING

WOULD YOU, as a lender, like to repay a bankruptcy trustee the loan payments you received months or even years before a bankruptcy was filed? Would you like a bankruptcy trustee to avoid your lien, leaving you to share in a pro rata distribution with unsecured creditors? Obviously, the answer to both questions is a resounding "No!" Yet, if not careful, you could see this happen in a debtor/borrower's bankruptcy proceeding.

The Bankruptcy Code allows trustees to avoid and recover preferential transfers and constructively fraudulent conveyances that debtors made prior to their bankruptcy filings. This article addresses the basic concepts underlying preferential transfers and fraudulent conveyances,

identifies common situations where transactions can be avoided, and discusses steps lenders can take to minimize their risk. Finally, it provides practical pointers for dealing with bad situations.

### What Is a Preferential Transfer?

A preferential transfer enables, or "prefers," a creditor to receive more than it would have if the transfer had not been made and the creditor had simply received a distribution from the bankruptcy estate. The most obvious example of a transfer is the payment of cash from a borrower to a lender. But that's just the beginning. A "transfer" can also include the granting of a security interest, the perfection of a security interest, the recording of a mortgage or deed of trust, the assignment of a property right, a garnishment, a foreclosure, the attachment of a judgment lien, etc. A preferential transfer can even occur when a borrower uses one credit card to pay off the balance on another credit card.

Typically, a trustee can avoid only those transfers that occurred during the 90-day period prior to the bankruptcy filing. But if the creditor is an *insider*, the trustee can avoid transfers that were made as far back as one year prior to the filing. If a lender exercises some significant control or influence over the debtor, it could potentially be deemed an insider.

### How Preferential Transfers Can Be Used against Lenders

If a mortgage was granted two years earlier but the lender failed to record it until sometime during the 90-day period preceding bankruptcy, then the recording of the mortgage would be preferential and could be avoided. Similarly, filing a corrective deed of trust during the 90-day period to fix some defect (such as an error in the legal description of the real property) would be considered a preferential transfer because it fully perfects the lender's lien.

In the context of personal property, if a UCC financing statement is filed outside the statutorily allowed time period, the recording (perfection) of that security interest

would be deemed preferential. If a UCC continuation statement is not filed in a timely manner, thereby necessitating the filing of a new UCC-1 financing statement, such a filing would be deemed preferential because

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it would allow the creditor to go from unperfected to perfected status. In these situations, the trustee would avoid the filing of the UCC financing statement and use his "strong arm" powers to knock out the lender's secured but unperfected security interest in the collateral.

Consider a lender who loans money secured by collateral that has a diminishing value over time. As a result of the deterioration in value, the lender demands (and the borrower provides) additional collateral to further secure the indebtedness. If the granting of the additional collateral occurs in the 90-day period, it could be deemed a preferential transfer.

What if the lender is partially secured? Whether a preference occurs depends on how the lender applies the funds. This issue is particularly likely in situations involving forbearance agreements, where the borrower/debtor continues to make payments. If the money is used to reduce the principal indebtedness secured by the property, then the payments would not be preferential. Conversely, if the lender applies the loan payments to cover attorney's fees or default interest (rather than the principal obligation owed), such payments are recoverable as preferential.

### What Is a Constructively Fraudulent Conveyance?

Constructively fraudulent conveyances typically occur in commercial settings and do not involve bad intent. To avoid a constructively fraudulent transfer, the trustee must show that the debtor received less than "reasonably equivalent value" in exchange for the transfer and was either insolvent or had insufficient ability to continue its

business operations. The Bankruptcy Code incorporates state law that typically allows the avoidance of any constructively fraudulent conveyance that occurred up to four years before the bankruptcy filing.

Reasonably equivalent value need not be an identical, dollar-for-dollar exchange—just relatively close. An exchange of real estate valued at \$90,000 for stock that had an estimated value of \$100,000 would be reasonably equivalent. Real estate valued at \$90,000 exchanged for stock valued at \$10,000 would not be.

We can view reasonably equivalent value from the perspective of the debtor's balance sheet. If a lender loans \$50,000 and the borrower repays it, then the dollar-for-dollar reduction in debt is considered reasonably equivalent value: The borrower's assets decreased by \$50,000 owing to the loan repayment, but at the same time there was a corresponding \$50,000 reduction in liabilities. Thus, the payment was for reasonably equivalent value.

Ironically, a lender may provide a significant benefit to a borrower that does not result in a reasonably equivalent exchange of value. A lender could agree to forbear from declaring a loan default in exchange for the borrower/debtor pledging additional collateral. This creates a significant benefit for the borrower—it lives to see another day. But from a balance sheet perspective, the borrower did not receive any reasonably equivalent value for the transaction because it pledged unencumbered property as a security interest and did not receive any tangible value that could be added to the asset side of the ledger.

The other major component of a constructively fraudulent conveyance is that the debtor/borrower must be either insolvent or have insufficient assets to sustain ongoing operations. Insolvency is the most common of these alternatives and is determined on a balance sheet basis. Identifying an entity's liabilities is not too hard. But determining an appropriate value for the assets can be difficult. If the company is an active entity with reasonable prospects of ongoing operations, then the going-concern value should be used for its assets. But if the company is on its deathbed, the courts will apply a liquidation valuation to its assets in determining solvency at the time the transfer occurred.

### How Have Constructively Fraudulent Conveyances Been Used against Lenders?

A very common situation involves a scenario where the underlying collateral that secures a loan has deteriorated and the lender demands additional collateral to prevent default and foreclosure. The lender becomes subject to a constructively fraudulent conveyance claim when it receives additional security without giving any corresponding benefit to the borrower/debtor.



A constructively fraudulent conveyance can occur when a lender requires two affiliated borrowers to be co-signers on a promissory note but money is paid only by one. The entity that co-signed the note does not receive any value from the transaction but is suddenly saddled with new debt. The incursion of that new debt is avoidable. Similarly, if a lender requires an affiliated company to guarantee a loan but the guarantor does not receive reasonably equivalent value, the guaranty can be avoided. In both situations, if a lender hopes to uphold the transaction it must show there was reasonably equivalent value received in exchange for signing the promissory note or guaranty.

Lenders need to be wary about who is actually repaying the debt. If a husband uses his own funds to repay a debt that is in his wife's name only, the payment can be avoided because the marital peace and fidelity that was created at home does not constitute reasonably equivalent value from the perspective of the husband's creditors. In a small-business setting, if the owner causes his wholly owned corporation to make the monthly mortgage payments on his personal residence, those payments can be avoided because the corporation did not receive value in exchange for the transfers. Similarly, if there are two sister corporations and Corporation A pays the debt of Corporation B, Corporation A's payments can be avoided as constructively fraudulent if Corporation A did not receive reasonably equivalent value in return.

Whether value has been received will sometimes depend on the solvency status of another entity. If a parent corporation guarantees (or even pays down) the debt of its subsidiary, the parent will be deemed to have received reasonably equivalent value if there is equity in the subsidiary. But if the subsidiary remains insolvent following the transaction, the parent company's balance sheet will not have benefited and such a transfer would be voidable.

Loan restructurings can be particularly problematic. Suppose there is a holding company with debts owed to Bank A. The holding company has a subsidiary with unencumbered assets. As part of the restructuring, the holding company obtains a loan from Bank B and the proceeds are used to pay off Bank A. As part of the loan with Bank B, the holding company causes its subsidiary to pledge its assets as collateral for Bank B's loan to the holding company. In that situation, the subsidiary corporation does not receive any reasonably equivalent value, and thus

the security interest that the subsidiary gave to Bank B could be voided as a constructively fraudulent conveyance.

### How Can Lenders Protect Themselves?

As a lender, you may want to consider the following pointers:

**Educate yourself and your staff.** Knowing how to spot the red flags means you will avoid the pitfalls of avoidance actions. Make sure you have rock-solid procedures for appropriately documenting mortgages, deeds of trust, and security agreements, and for their timely filing in the right location.

**Know the borrower.** Know your borrowers and their financial condition. Maintain good lines of communication. Carefully monitor the value of the underlying collateral. Make sure loan covenants are properly enforced. Periodically request documentation to confirm how the borrower is repaying you.

**Know the transaction.** Knowing the transaction means truly understanding 1) how it is supposed to work on paper, and 2) how it is *actually* working in practice. Prior to making the loan, the lender must understand the debtor's cash management system and how it will repay its debts. The borrower must understand its responsibilities and exactly who is to repay the debt. Diagram multiparty transactions to help spot potential traps. Confirm that the repayments are being made by the proper party and in accordance with the loan agreement. Pay attention to how well corporate formalities are followed. If the borrower/debtor continually plays fast and loose with either the company's books or corporate formalities, a lender may face heightened risk of an avoidance action.

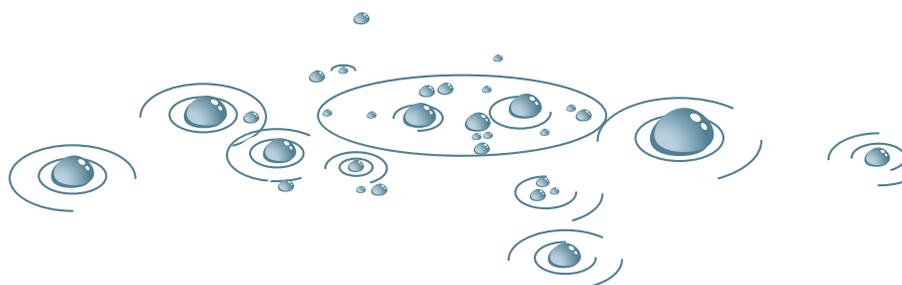
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**Make sure you remain oversecured.** The easiest defense to a preferential transfer comes by showing that the creditor was oversecured when the transfer was made. Closely monitor the value of the collateral. If the loan-to-value ratio deteriorates, seek to obtain additional collateral before you become undersecured. Why is this so essential?

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## By knowing and dealing appropriately with these risks, lenders can minimize their exposure and focus on maximizing the bottom line.

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A bankruptcy trustee may be able to avoid the pledge of new collateral that moves you from an undersecured to an oversecured position.

*Carefully think through loan restructurings.* Will any new collateral be pledged? What value is the lender receiving through the restructuring? What value is the bank obtaining and from whom? How does the entity that pledges new collateral benefit from the restructuring?

*Identify the concrete value the borrower receives.* In multiparty loan agreements, identify which entity receives the loan proceeds and which becomes obligated to repay the loan. An immediate red flag should pop up if one entity is either guaranteeing the loan or pledging collateral to support the loan but not receiving the loan proceeds. In those situations, can you identify the concrete value that such a party is receiving because of the transaction? If not, you may be walking on thin ice.

*Be prepared to throw your compatriots under the bus.* If a bankruptcy trustee seeks to avoid payments on a participated loan, the lead lender will argue that it was a mere conduit for the payment and that the holders of the participated loan interests are the real parties that should be liable. When looking to buy a participated interest, closely analyze the language of the participation agreement

and determine who will ultimately bear responsibility for an avoidable transfer.

### How Do You Deal with a Bad Situation?

If a bankruptcy filing is increasingly likely, consider steps that would delay it. These could include entering into a forbearance agreement, restructuring the loan, or holding off on declaring a default. If there have been questionable payments from affiliated debtors, work with the borrower/debtor to ensure that payments are properly made going forward. Correcting the situation can help minimize future avoidance action claims.

### Conclusion

Preferential transfers and constructively fraudulent conveyances can be complicated. They pose real risks that lenders cannot ignore when dealing with financially troubled debtors. Prudent lenders will seek out competent legal counsel to help them navigate these legal minefields. By knowing and dealing appropriately with these risks, lenders can minimize their exposure and focus on maximizing the bottom line. ❖



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