Legal Corner

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"Fraudulent Transfers"

In this final column on bankruptcy, we will explore an issue that has become increasingly troublesome for creditors, including many contractors...the fraudulent transfer. Last month, we discussed the ability of a trustee for a bankrupt company to recover preferential payments made within 90 days of a bankruptcy filing. Under the provisions entitled fraudulent transfers, the trustee can also recover payments received prior to a debtor's bankruptcy.

A recovery under a fraudulent transfer theory has the potential to involve much more money than a preference, because the trustee may recover all payments made within **two years** of the bankruptcy filing (although the debtor must be insolvent when a transfer is made, and because most companies cannot operate while insolvent for so long, the period during which payments are at risk should, as a practical matter, be much less than two years).

By its very name, one would assume that a "fraudulent" transfer requires some wrongdoing on the part of a contractor/creditor, and that so long as a creditor engages in fair business practices, a debtor should have no basis for alleging that a creditor's actions constitute fraud. Wrongful assumption! Every creditor is at risk for receiving (and having to pay back) a payment deemed to be a fraudulent transfer.

A fraudulent transfer falls into two categories.

The first type of fraudulent transfer involves actual fraud – when a debtor transfers property or cash for the purpose of keeping the money or property away from creditors. For example, a debtor's corporate assets may be transferred to relatives, or to a separate legal entity, so that creditors cannot reach the assets. The payment or transfer is fraudulent if the debtor actually intended to hinder or defraud creditors (i.e., the debtor knew he was committing fraud).

The second type of fraudulent transfer involves a payment made while the debtor was insolvent, for which the debtor received *less than reasonably equivalent value* in exchange for the payment. Although the debtor did not intend to defraud anyone by making the payment, the payment is "constructively fraudulent" because the debtor transferred property without adequate consideration. Under bankruptcy law, a trustee may recover any "constructively fraudulent" payments made within two years of the bankruptcy filing.

Still, it is far from clear as to how a payment would be for less than reasonably equivalent value. A price should be fair if

1. a contract or invoice established the price that would be paid for the creditor's services or products,
2. the debtor paid the agreed-upon price, and
3. the price is about the same as other customers pay for similar products or services. In these circumstances, how can the products or services be worth less than what the debtor paid?

The answer has to do with how the debtor structures its business and finances. In larger companies, it is not uncommon for a parent company to use cash management techniques whereby the parent pays the bills of the subsidiaries. Such payments by the cash management entity may be constructively fraudulent because the parent had no obligation to pay the bills and did not receive a benefit in return. By performing work for the debtor, but receiv-

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ing payment from the debtor's parent, a creditor may receive a fraudulent transfer. Some courts have held that under these facts, the parent company did not benefit from the creditor's work, and the payment was fraudulent because the parent received less in return than it paid to the creditor. The trustee may sue to recover the payment on the grounds that it was a fraudulent transfer.

A creditor who receives the payments may have no idea that the payment is not from the debtor itself, because the checks may even have the debtor's name printed on them. Cash management systems, which are often used by large companies with multiple subsidiaries, have paved the way for an increase in fraudulent transfer litigation.

A cash management system works by sweeping all of the subsidiaries' accounts, usually on a daily basis, into an account owned by the parent. The parent then makes payments for its subsidiaries directly from the central account. In this manner, the subsidiaries may never directly pay any of their creditors. However, once the funds are commingled and under the sole control of the parent, the funds may be considered the sole property of the parent.

When the entire enterprise files for bankruptcy, all payments made by the parent for its subsidiaries' debts may be characterized as fraudulent, and the parent may seek to recover all of the funds paid when the parent was insolvent, for up to two years before the bankruptcy filing. Creditors may routinely accept payments from such accounts without ever realizing that the payment is not made from its customer's own checking account.

This result may be counterintuitive. If the parent took all of the subsidiary's money, then it seems right that the parent should pay the subsidiary's debts. Further, a parent company should benefit when its subsidiary completes a project or receives inventory. However, some courts find that once money is deposited into a cash management account, it becomes the parent's sole asset. Unless the subsidiary has control over the funds, the legal title to the funds is in the parent. And if the parent is also insolvent, courts have found that the parent receives no benefit from that fact that its subsidiary is "less insolvent."

If a client or customer is a subsidiary of a larger company, ask whether the parent will guarantee payments on a job. If a parent is obligated on a contract, the parent will have a more difficult time claiming that it received no benefit from the contract.

What can creditors do to protect against this risk? In nearly all situations, creditors should accept payments from their customers. Knowing how a customer is structured, particularly whether it is a subsidiary of a parent company is important when entering into a contract.

If a client or customer is a subsidiary of a larger company, ask whether the parent will guarantee payments on a job. If a parent is obligated on a contract, the parent will have a more difficult time claiming that it received no benefit from the contract.

Similarly, the parent may acknowledge in the contract that it will receive a direct and substantial benefit from the completion of its subsidiary's contract. These factors may assist in defending against a fraudulent transfer claim, but this is an evolving area of law, and we will continue to monitor the court rulings in these cases.

As we have shown in the past articles, bankruptcy is complicated and aspects of bankruptcy are likely to impact all entities involved in construction. Consultation with competent counsel is a must in such circumstances. ■