FRAUDULENT AND PREFERENTIAL TRANSFER ISSUES CONCERNING STRUCTURED FINANCINGS

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I. *Definition of Special Purpose Vehicle ("SPV"):*

A. Typically, an SPV is an entity (often a limited liability corporation or business trust) that is formed as a subsidiary of the parent company (the "Seller") for the purpose of purchasing certain assets of the Seller (often accounts). The SPV finances the purchase price (through loans from institutional lenders or the issuance of commercial paper) and repays the loan through the cash flow from the purchased assets. The SPV's activities are usually limited to holding title to the transferred assets and collecting and distributing the proceeds of such assets.

SPVs are utilized most often in the securitization, or structured financing, of accounts receivable. The SPV should be a "bankruptcy remote" entity that would not be effected by a bankruptcy of the Seller. In addition, an SPV's by-laws often contain provisions restricting the SPV's ability to file a bankruptcy petition. Thus, an SPV is also referred to as a bankruptcy remote vehicle or "BRV."

II. *Purposes of an SPV:*

A. To convert unique financial assets into marketable standardized assets; to protect such assets from the claims of third-parties, and to protect such assets from a bankruptcy of the Parent. The bankruptcy remote nature of SPVs and the diversification of risk by pooling assets in an SPV enables the Seller to obtain funding at effectively lower interest rates than if the assets were subject to claims of the Seller's creditors.

III. *Typical Documentation of Structured Financing Involving an SPV:*

The closing documents in a structured financing involving an SPV often include, but are not limited to, the following:

A. Articles of Incorporation and By-laws of SPV;

B. Agreement of Purchase and Sale/Assignment Agreement between parent and SPV;

C. Loan Agreement between SPV and lender;

D. Security Agreement between SPV and lender;

E. Guaranty by Seller of the validity of the assets sold to the SPV.

IV. *Fraudulent Transfer Law:*

A. *Section 548 of the Bankruptcy Code:*

1. *Text of Statute:* Section 548 of the Bankruptcy Code, 11 U.S.C. Section 548, provides as follows:

> A trustee may avoid any transfer of a debtor's interest in property or any obligation that was made or incurred on or within one year before the date of the filing of the petition:
>
> (1) if the transfer was made with the "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
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> (2) if the debtor received less than reasonably equivalent value in exchange for such transfer; and,
>
> (A) was insolvent on the date that such transfer was made or such obligation incurred or became insolvent as a result of such transfer or obligation;
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> (B) 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
>
> (C) intended to incur, or believe that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

2. *"Value" Defined:* Section 548(d)(2), in relevant part, defines "value" for purposes of Section 548 as "property, or satisfaction or securing of a present or antecedent debt of the debtor."

3. *Statute of Limitations:* Pursuant to Section 546 of the Bankruptcy Code, 11 U.S.C. Section 546,

> an action or proceeding under section . . . 548 of this title may not be commenced after the earlier of - -
>
> (A) the later of - -
>
> (i) 2 years after the entry of the order for relief;
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> (ii) 1 year after the appointment or election of the first trustee . . .; or

(B) the time the case is closed or dismissed.

B. *The Uniform Fraudulent Transfer Act ("UFTA"):*

1. *Text of Statute:* Pursuant to the UFTA, a plaintiff may avoid a transfer if the transfer was made:

(1) with actual intent to hinder, delay, or defraud any creditor of the debtor;

(2) without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor;

(A) was insolvent;

(B) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

(c) intended to incur, or believed or reasonably should have believed that he would incur, debts beyond his ability to pay as they became due.

2. The UFTA has been adopted in 33 states.

3. *"Value" Defined:* Pursuant to Section 3 of the UFTA, "[v]alue is given for a transfer or an obligation if, in exchange for the transfer or obligation, property is transferred or antecedent debt is secured or satisfied."

4. *Statute of Limitations:* The statute of limitations for fraudulent transfers under the UFTA is four years.

C. *Section 544 of the Bankruptcy Code*

1. *Text of Statute:* Section 544(b) of the Bankruptcy Code, provides that "[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 by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title." 11 U.S.C. Section 544(b).

2. Section 544(b) authorizes the trustee to avoid any transaction of the debtor that would be voidable by any actual unsecured creditor under state law and therefore to assert a claim under the relevant state fraudulent conveyance law. In re Image Worldwide, Ltd., 139 F.3d 574, 576-139 (7th Cir. 1998).

D. *Downstream Transfers as Fraudulent Transfers*

1. *To Solvent Subsidiaries:* In general, where a parent corporation makes a transfer to, pays, or guarantees the debt of, a solvent subsidiary, the parent corporation receives "reasonably equivalent value," 11 U.S.C. § 548(a)(2)(A), in return. E.g., In re W.T. Grant Co., 699 F.2d 599, 608-09 (2d Cir.) (Through its subsidiary, the debtor received the full benefit of the short-term loans and additional loans in return for its guaranty and security interests), cert. denied, 464 U.S. 822 (1983); In re Lawrence Paperboard Corp., 76 B.R. 866, 871 (Bankr. D.Mass. 1987) (downstream guaranties, were supported by fair consideration, since parent corporation received the benefit of any loans by creditor as a result of its stock ownership); In re First City Bancorporation of Texas, Inc., 1995 Bankr. Lexis 1683, at *34 n.9 (Bankr. N.D.Tex. May 15, 1995) (a transfer to a wholly-owned solvent subsidiary is often for reasonably equivalent value, because the value of the parent's stock interest in the subsidiary may be correspondingly increased).

2. *To Insolvent Subsidiaries:* Where a parent company pays or guarantees the debts of its insolvent subsidiary (i.e., a "downstream" transfer), the parent company may not receive reasonably equivalent value in exchange for its payments.

a. For example, in In re Duque Rodriguez, 77 B.R. 937, 939 (Bankr. S.D. Fla. 1987), aff'd, 895 F.2d 725 (11th Cir. 1990), the parent holding corporation paid the debt of an insolvent subsidiary. In the parent corporation's subsequent bankruptcy case, the trustee sought to avoid the transfer pursuant to § 548(a)(2) of the Bankruptcy Code on the grounds that the transfer was made while the parent corporation was insolvent and the parent did not receive reasonably equivalent value in exchange for the transfer. The defendant argued that the parent corporation indirectly received reasonably equivalent value in exchange for the transfer because the parent corporation owned the subsidiary. The court held that:

> [i]f [the subsidiary] had not been insolvent at the time its corporate parent paid the freight for goods delivered to [the subsidiary] and if [the subsidiary] had not subsequently filed for bankruptcy, I would find that [the corporate parent] had received an indirect benefit from the three-sided transaction in this case, a benefit at least equal in value to the sum it paid. But I cannot ignore the reality that, in view of [the subsidiary's] then terminal insolvency, the net worth of [the parent holding corporation] was diminished by the transfer and, therefore, the transfer was avoidable pursuant to Section 548(a)(2).

Id. at 939. See also Commerce Bank of Kansas City v. Achtenberg, 1993 WL 476510, at *2-4 (W.D. Mo. 1993) (debtors did not receive reasonably equivalent value in exchange for guaranty of wholly-owned insolvent corporation's debt because the debtor's net worth was diminished by the guarantee obligation); Branch v. Federal Deposit Ins. Corp., 825 F. Supp. 384, 400 (D. Mass. 1993) (complaint survived motion to dismiss where plaintiff alleged that transfers to solvent subsidiaries were not for reasonably equivalent value where the subsidiaries could be liable for guarantee debt in connection with hopelessly insolvent sister subsidiary); In re First City

Bancorporation of Texas, Inc., 1995 Bankr. Lexis 1683, at *34 n.9 (Bankr. N.D.Tex. May 15, 1995) (transfer to insolvent subsidiary is not for reasonably equivalent value because the parent's shares in the subsidiary have no value).

V. *Fraudulent Transfer Law in Structured Financings:*

A. *Properly Structured Financings:* In a properly structured securitization, the transfer of the Seller's assets to the SPV should be a true sale, rather than a disguised security interest. In addition, the SPV should be purchasing the Seller's assets for reasonably equivalent value. The Seller and the SPV should be separate and distinct entities so that the SPV is not likely to be substantively consolidated with the Seller. The SPV's business activities should be limited to the ownership and liquidation of the assets purchased from the Seller.

1. *Typical Transfers by Seller:*[1] The Seller typically makes, *inter alia*, the following payments, and incurs the following obligations, in a securitization:

a. Transfer of Seller's accounts receivable or other assets to the SPV;

b. Indemnify SPV for any receivable that is uncollectible for a reason other than the financial inability of the account debtor to pay the undisputed account;

c. Obligation to repurchase the Seller's accounts if the SPV (or ultimate purchaser) is unable to sell interests in the pooled accounts;

d. Grant of security interest in Seller's interest in accounts transferred to the SPV.

2. *Constructively Fraudulent Transfer:* In the typical structured financing, there is little risk of a fraudulent conveyance attack (although there are no published decisions involving fraudulent conveyance attacks on such transactions). The Seller receives a purchase price that approximates the face amount of the accounts transferred to the SPV in cash and subordinate notes of the SPV's lenders (less a discount for uncollectible accounts if the securitization involves a sale of accounts). Thus, the purchase price should be "reasonably equivalent value" for the accounts transferred to the SPV. See BFP v. RTC, 511 U.S. 531 (1994)

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[1]. The term "transfer" is defined, in relevant part, in the Bankruptcy Code as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary of disposing of or parting with property or with an interest in property, including retention of title as a security interest." 11 U.S.C. Section 101(54); see also UFTA Section 1.12 (containing substantially similar definition of "transfer").

("reasonably equivalent" value is "approximately" or "roughly" equivalent value).[2] As the Seller has received reasonably equivalent value, its creditors cannot satisfy the elements of a constructively fraudulent transfer claim under Section 548 of the Bankruptcy Code or Section §4(a)(2) of the UFTA. See Lynn M. Lopucki, *The Death of Liability*, 106 Yale L.J. 1, 27 & n.111 (October 1996); The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *Structured Financing Techniques*, 50 The Bus. Law. 527, 548 (February 1995).

3. *Intentionally Fraudulent Transfer*: A plaintiff may avoid an intentionally fraudulent transfer of assets under Section 548 of the Bankruptcy Code or Section §4 of the UFTA irrespective of the adequacy of the consideration paid by the transferee. Mussetter v. Lyke, 10 F.Supp.2d 944, 958 (N.D. Ill. 1998); U.S. v. Shepherd, 834 F.Supp. 175, 180 (N.D.Tex. 1993). Thus, a plaintiff may challenge a structured financing on the grounds that it was intended to "hinder" or "delay" the Seller's creditors notwithstanding that the Seller received reasonably equivalent value for its assets. Relying upon restrictions on filing voluntary bankruptcy petitions in an SPV's by-laws, a plaintiff would argue that the transfer of the Seller's assets to the SPV was intended to "hinder" or "delay" the parent-company creditors' efforts to reach those assets. See Lopucki, *The Death of Liability*, 106 Yale L.J. at 28 (describing structured financing as a "judgment proofing technique"). The lender would contend that the securitization was intended to enable the Seller to obtain capital at a much lower rate than if the transferred assets were subject to the claims of the Seller's creditors. In addition, the lender would argue the fact that the Seller received reasonably equivalent value for the assets evidences that the transaction was not intended to hinder or delay the Seller's creditors (who probably received at least a portion of the proceeds of the loan to the Seller).

Even if a plaintiff could establish an intent to "hinder" or "delay" creditors, the plaintiff would still have to prove damages to avoid the Seller's transfers as fraudulent transfers. See A/S Kreditt-Finans v. Cia Venetico De Navegacion S.A. of Panama, 560 F.Supp. 705-710-11 (E.D.Pa. 1983), aff'd without op., 729 F.2d 1446 (3d Cir. 1984); In re Morse Tool, Inc., 148 B.R. 97, 139 (Bankr. D.Mass. 1992). As the SPV paid reasonably equivalent value for the Seller's assets, the Seller's creditors may not be able to prove any damages from the transfer. Lopucki, *The Death of Liability*, 106 Yale L.J. at 27.

Structured financing is widespread. See Committee, *Structured Financing Techniques*, The Bus. Law. at 528 (noting that, as of 1995, securitizations accounted for $450 billion per year of financings in the United States). As a practical matter, therefore, It is unlikely that a court would create upheaval in the public capital market by concluding that a securitization, a commonly used vehicle for optimizing funds constituted an intentionally fraudulent transfer. In re

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[2] The fact that the Seller was effectively able to raise capital at a lower cost than the Seller could have borrowed absent a structured financing may also be relevant in determining whether the Seller received "reasonably equivalent value" for its accounts. See generally Mellon Bank v. Metro Communications, Inc., 945 F.2d 635, 647-48 (3d Cir. 1991) (ability to obtain credit is value for fraudulent conveyance purposes).

Cushman Bakery, 526 F.2d 23, 33 (5th Cir. 1975) (concluding that transfer was made for legitimate business purpose and was not fraudulent), cert. denied sub nom. Agger v. Seaboard Allied Milling Corp., 425 U.S. 937 (1976); Standard Dyeing and Finishing Co. v. Arma Textile Printers Corp., 757 F.Supp. 230, 236 (S.D.N.Y. 1991) (same). Professor Lopucki opines that judgment proofing via securitizations will become more widespread and will produce a future in which "[t]here will be entities that own things and entities that do things. Those that own things — the bankruptcy remote vehicles — will not do anything, lest they expose their assets to liability. Those that do things — the operating companies — will not own anything, lest their judgment creditors have something to attach." Lopucki, *The Death of Liability*, 106 Yale L.J. at 28.

B. *Problems Created by Structured Financings:* What if the SPV overpays or underpays for the Seller's assets? What if the Seller guarantees the debts of an insolvent SPV? What if the transfer of assets to the SPV was not a true sale?

1. *If the SPV Overpays:* If the SPV overpays for the Seller's assets, the Seller has received more than reasonably equivalent value. Any fraudulent transfer challenge should be unsuccessful.

2. *If the SPV Underpays:* If the SPV underpays for the Seller's assets, a fraudulent transfer challenge should still be unsuccessful. The SPV should be solvent as its assets exceed the amount borrowed and transferred to the Seller as payment for those assets. As the Seller owns the stock in the SPV, the Seller would still benefit from the downstream transfer — even though the assets were sold for less than their value.

3. If the SPV Commingles: If the SPV collects accounts as an agent for assignee then commingles collected money with money from other sources, it may be deemed that the transfer is fraudulent. Thole v. Delmonico Garage, Inc., 47 F.Supp. 601 (S.D.N.Y. 1942).

C. *If the Seller Guarantees the SPV's Obligations to its Lender:*

a. Where the SPV is Solvent: The Seller's downstream guarantee of the SPV's obligations to the lender that financed the purchase of the Seller's assets should not be avoidable. See *supra* at Section IV.D(1).

b. Where the SPV is Insolvent: The downstream guarantee may be avoidable. If the SPV had no other assets and was insolvent solely as a result of overpaying for the Seller's assets, the guarantee should not be avoidable. The Seller would have received a purchase price for its assets greater than the value of those assets and its exposure on the guarantee.

If, however, the SPV were insolvent as a result of other obligations unrelated to the financing of the purchase of the Seller's assets, the downstream guarantee may be avoidable if the SPV underpaid for the Seller's assets. The issue would be whether the purchase price for the Seller's assets was not reasonably equivalent value for those assets. Moreover, as the SPV is insolvent, it is likely that the Seller will be called upon to pay the SPV's lender. See

infra at Section IV.D(2). However, SPV's typically are prohibited from incurring obligations to other than to the Seller or the Lenders.

D. *If the Transfer of Assets to the SPV Was Not a True Sale*: The same analyses set forth in Sections 3(a)-(c) should still apply except that the Lenders would be treated as having a security interest in the Seller's accounts receivable and, upon a Seller's bankruptcy, the automatic stay would stay the enforcement of the Lender's rights in the assets.

VI. *Preferential Transfer Law in Structured Financings:*

A. *Section 547 of the Bankruptcy Code*

1. *Text of Statute:* Section 547(b) provides:

> (b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property-
>
> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made
>
> > (A) on or within 90 days before the date of the filing of the petition; or
> >
> > (B) between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider[3]; and

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[3] Section 101(31)(B), in relevant part, defines "insider" as including:

(B) if the debtor is a corporation--
- (i) director of the debtor;
- (ii) officer of the debtor;
- (iii) person in control of the debtor;
- (iv) partnership in which the debtor is a general partner;
- (v) general partner of the debtor; or
- (vi) relative of a general partner, director, officer or person in control of the debtor;

. . .

(5) that enables such creditor to receive more than such creditor would receive if--

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

2. *Statute of Limitations:* Same as Section IV.B(4) *supra*.

3. *Defenses under Section 547(c):* Section 547(c)(1), (2), (3), (4) and (5) provide potentially relevant defenses to the avoidance of a preferential transfer under Section 547(b) in the context of structured financing. Without setting forth the text of each defense, suffice it to say that the defenses protect transfers that do not result in improvement in a creditor's position. Thus, where a creditor provides new value contemporaneous with, or subsequent to, a preferential transfer, the transfer may not be avoided. <u>See</u> 11 U.S.C. Section 547(c)(1) and (4). Where the creditor's security interest attaches to additional accounts receivable, such attachment is not avoidable where the secured creditor did not improve its position. <u>See</u> 11 U.S.C. Section 547(c)(5).

4. *Continuing Transfers to an SPV*: Where a Seller has continuing obligations to make transfers to the SPV, those transfers may be subject to preferential transfer claims.

a. Where a Seller is required to make a payment or transfer additional accounts to the SPV due to the uncollectibility of previously sold accounts, such transfer may be avoidable under Section 547(b) and not entitled to the protections of any defense in Section 547(c). The transfer would be on account of "antecedent debt" and would probably be avoidable if the Seller was insolvent at the time of the transfer. But an SPV may have a security interest to secure seller's obligations.

b. Where a Seller is required to repurchase accounts because the SPV (or ultimate purchaser) is unable to sell interests in the pooled accounts also may be avoidable under Section 547(b). The transfer is on account of antecedent debt. Thus, if the Seller was insolvent at the time of the transfer, the payment may be avoidable (at least in part). To the extent that the accounts had value, the transfer would

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(E) affiliate, or insider of an affiliate as if such affiliate were the debtor; and
(F) managing agent of the debtor.

11 U.S.C. Section 101(32)(B), (E) and (F).

probably be protected from avoidance under Section 547(c)(1) or (4).

5. *Transfers in "Not True Sales"; Commingling*: If the Seller retains a residual interest in accounts transferred to an SPV, or if a payment to the SPV originates from commingled funds, the SPV may have potential preference exposure.

a. Illustration: Assume Seller "Sells" $100 million in accounts to the SPV in exchange for $80 million. The Seller (as servicer) collects $60 million of those accounts in the following month. Assume further that the Seller generates $40 million in new accounts during that following month. Pursuant to the financing documents, the SPV purchases accounts as they are created for eighty percent (80%) of the face value, but only one net transfer between the Seller and the SPV is made at the end a month. Thus, in our example, the Seller would owe $28 million to the SPV (which is calculated by subtracting the $32 million purchase price for the $42 million in accounts from the $60 million collected).

b. Potential Preference Risk: Depending upon whether the Seller had an residual interest in the accounts or whether the $28 million came from a commingled account, the SPV may have potential preference exposure.

(1) Seller's Residual Interest: Where the Seller has a residual interest in the accounts, the structured financing may be deemed to be a loan, rather than a sale, transaction. In that case, the accounts will be property of the estate under 11 U.S.C. § 541(a). To protect the $28 million transfer from avoidance, the SPV would have to prove that the transfer was made in the ordinary course of business under Section 547(c)(2). In addition, the bankruptcy court would undertake the improvement in position analysis under Section 547(c)(5) to determine if any portion of the SPV 's security interest in the Seller's accounts was avoidable.

(2) Commingled Funds: If the $60 million was commingled with other funds of the Seller (whether the transfer was a "true sale" or a loan), the $28 million transfer may constitute a transfer of the Seller's property for purposes of Section 547(a) if the SPV could not trace the $28 million to its $60 million.