

# Fraudulent transfers under the bankruptcy code

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The old adage "nothing in life is free" is a time-honored principle that is embodied in the Bankruptcy Code's fraudulent transfer provisions. 11 U.S.C. § 101 et seq. It is tempting for a debtor to transfer assets to a relative or friend on the eve of bankruptcy in exchange for little or no consideration in the hope of frustrating creditors' attempts to reach those assets. Recognizing that such temptation would be great, Congress enacted specific provisions barring such transfers. More specifically, § 548 of the Bankruptcy Code allows a trustee to avoid fraudulent transfers that occur within one year before a bankruptcy filing.<sup>1</sup> 11 U.S.C. § 548. As such, anyone who received property from a debtor for free or even for minimal consideration prior to a bankruptcy filing may find that those assets are subject to a fraudulent transfer action by the bankruptcy trustee.

The purpose of fraudulent transfer law is "to preserve assets of the estate for creditors." *In re Image Worldwide, Ltd.*, 139 F.3d 574, 578 (7th Cir. 1998); *In re Roti*, 271 B.R. 281, 294 (Bankr. N.D. Ill. 2002) ("Fraudulent conveyance law protects creditors from last-minute diminutions of the pool of assets in which they have interests.") (quoting *Bonded Fin. Servs., Inc. v. European Am. Bank*, 838 F.2d 890, 892 (7th Cir. 1988)). Fraudulent transfers fall under one of two categories: (1) actually fraudulent or (2) constructively fraudulent.

## Actual fraud

A transfer is actually fraudulent if it was made "with actual intent to hinder, delay, or defraud any entity to which the debtor was or became...indebted." 11 U.S.C. § 548(a)(1)(A). "The focus in the inquiry into actual intent is on the state of mind of the debtor. Neither malice nor insolvency are [sic] required. Culpability of the part of...the [recipient of a fraudulent transfer] is not essential." *In re Roti*, 271 B.R. 281, 294 (Bankr. N.D. Ill. 2002) (quoting *In re Cohen*, 199 B.R. 709, 716-17 (9th Cir. B.A.P. 1996)). Because it is difficult to prove that the debtor acted with intent to defraud its creditors, courts rely upon certain "badges" of fraud to prove intent. Such badges include:

- (1) absconding with the proceeds of the transfer immediately after their receipt;
- (2) absence of consideration when the transferor and transferee know that outstanding creditors will not be paid;
- (3) huge disparity in value between the property transferred and the consideration received;
- (4) fact that the transferee was an officer, or agent or creditor of an officer of corporate transferor;
- (5) insolvency of the debtor; and
- (6) existence of a special relationship between the debtor and the transferee. *Id.*

## Constructive fraud

Constructive fraud differs from actual fraud in that the debtor's intent is of no import. A transfer is constructively fraudulent if: (1) the debtor received less than reasonably equivalent value in exchange for the transfer and (2) the debtor was (a) insolvent on the date of the transfer or became insolvent as a result of the transfer, (b) the debtor was engaged or was about to engage in a business or transaction for which any property remaining with the debtor was an unreasonably small capital, or (c) the debtor intended to incur or believed that it would

incur debts beyond the debtor's ability to pay as such debts matured. 11 U.S.C. § 548(a) § (1)(B).

The cornerstone of a constructively fraudulent transfer is "reasonably equivalent value." "Determination of reasonably equivalent value under § 548(a)(1)(B) is a two-step process" which requires the Court (1) to determine whether the debtor received value and (2) to examine whether the value is reasonably equivalent to what the debtor gave. *Roti*, 271 B.R. at 294-95. Although the Bankruptcy Code does not define "reasonably equivalent value," courts look to certain factors, including: "(1) whether the value of what was transferred is equal to the value of what was received; (2) the market value of what was transferred and received; (3) whether the transaction took place at an arm's length; and (4) the good faith of the transferee." *Id.* (citing *Barber v. Golden Seed Co., Inc.*, 129 F.3d 382, 387 (7th Cir. 1997)).

While there is no set formula for determining reasonably equivalent value, the bankruptcy court will review the facts of each case with a view towards the fair market value of the property transferred. *Id.*

In short, § 548 seeks to deter debtors from attempting to circumvent the orderly distribution process established by the Bankruptcy Code and to maximize assets that are property of the estate. As such, debtors should think twice before transferring assets prior to seeking bankruptcy relief, while recipients of such assets should be aware that they may one day be subject to an action by the trustee.

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1. The Bankruptcy Code also allows the trustee to rely on state fraudulent transfer law as long as there is at least one actual creditor in existence who would be able to attack the transfer under state law. 11 U.S.C. § 544(b). The Illinois Uniform Fraudulent Transfer Act, 740 ILCS 160/1 et seq., for example, authorizes the avoidance of a fraudulent transfer made as far back as four years prior to the filing of the bankruptcy petition.