

MITIGATING FRAUDULENT RISK

BY STEVEN S. SCHOLLES, MCDERMOTT

The recent financial crisis has caused a tremendous amount of distress. Falling revenues, difficulty in making debt payments and reduced asset values have caused many companies to take varying actions to shore up their balance sheets, including selling assets they would not otherwise sell. These sales may well be beneficial to both seller and buyer – the financially distressed seller receives additional capital, and the purchaser receives assets most likely at a favorable price. In these difficult economic times, however, a purchaser of assets from a troubled seller – and the purchaser’s counsel – must be aware of, and attempt to mitigate, the risk that sales may be challenged as fraudulent conveyances by the selling company’s creditors.

The law of fraudulent conveyances is old and very well-established. With roots in the common law dating to the 16th century, the law of fraudulent conveyances has been codified in the Uniform Fraudulent Conveyance Act, the successor Uniform Fraudulent Transfer Act and in the Bankruptcy Code. Through these statutes, creditors have a measure of protection against the diminution in value of the estates of defaulting debtors. Beneficial though the doctrine may be to creditors, companies purchasing assets from financially distressed sellers face a significant risk that the transaction may be challenged as fraudulent and ultimately set aside.

There are two primary types of fraudulent conveyances, constructive fraudulent conveyances and intentional fraudulent conveyances. Constructive fraudulent conveyances do not involve any intention on the part of the debtor to harm or delay its creditors. Generally speaking, a constructive fraudulent conveyance occurs if a debtor transfers assets for less than the reasonably equivalent value of those assets, provided that the debtor was either insolvent at the time of the transfer or was rendered insolvent by the transfer. The law deems such a transfer fraudulent, even though the debtor may not have intended to harm its creditors, because the transfer reduces the value of the debtor’s estate by the difference between the value of the assets the debtor transferred and the lesser value of the assets the debtor received in exchange. In such a situation, there are simply fewer assets remaining to satisfy the creditors’ claims. And this is so even if the buyer acted in complete good faith, without any knowledge, much less intention, that the transfer would harm the seller’s creditors.

An intentionally fraudulent conveyance is what its name implies -- a transfer of assets made by a debtor for less than reasonably equivalent value, with the intention of avoiding creditors. However, unlike a constructively fraudulent transfer, there is no requirement that the seller be insolvent at the time of, or rendered insolvent by, the transfer. Moreover, even if the seller intends to harm its creditors, if the ill-intentioned debtor receives reasonably equivalent value, the transaction is not fraudulent, unless the purchaser knew or should have known of the fraudulent intent. In such a situation, the value of the debtor’s estate is not diminished by the transfer of assets if the seller receives fair value.

If a transfer is deemed either constructively or intentionally fraudulent, the transaction may be set aside, or as more commonly occurs, the purchaser may be held liable to creditors for money damages. Money damages are typically the greater of: (i) the amount by which the value of the assets conveyed by the debtor exceeds the value of the consideration the debtor received for those assets; or (ii) the amount of the debt the seller owed to a particular creditor or creditors. Even innocent bona fide purchasers can be required to give up the assets purchased from the debtor or to pay money damages. If so, while the innocent purchaser may seek to recover such liabilities from the debtor, that is usually a worthless claim, because the debtor will likely be judgment proof.

Valuation issues are critical in fraudulent transfer cases, both with respect to the assets the debtor transferred and with respect to the assets the debtor received. As a general matter, if these values are reasonably equivalent, there is no fraudulent transfer, even if the debtor is insolvent, because the value of the debtor’s estate was not diminished by the transfer.

Given this state of the law, when a company purchases assets from a financially distressed seller, the purchaser and its counsel must be cognizant of the risk that the sale could be challenged as fraudulent, and they should take appropriate precautions to mitigate this risk. An understanding of valuation issues in fraudulent conveyance cases is critical to developing effective risk mitigation strategies.

Some valuation issues are obvious. While relatively liquid assets are easy to value and rarely the subject of disputes,

illiquid assets, such as physical property and certain intangible assets, may pose significant valuation challenges. Courts will usually value assets by trying to determine what a willing buyer would pay a willing seller in the open market, both with access to reasonable information and neither acting under compulsion or duress. Even this relatively simple test, however, is subject to widely varying application. Expert valuation witnesses can reach significantly varying conclusions as to values, and courts may have differing approaches to valuation, making even simple comparisons difficult between different courts, and even between different judges sitting on the same court. Because valuation may be more art than science, valuation issues are commonly litigated.

While there is no certain way to eliminate the risk that a creditor may challenge a purchase as having been made for less than reasonably equivalent value, the risk can be mitigated by documenting contemporaneous valuation analyses of such assets. Accounting and appraisal firms commonly perform this work, but it may be done internally by the purchaser's own employees as well. A thorough, well-reasoned and well-documented analysis performed before the closing of the transaction should provide powerful evidence of valuation in any post-closing dispute.

Other valuation issues are less obvious. For example, purchases of assets from multiple companies in a single corporate family

pose particular problems if the buyer pays the parent company for the assets of its subsidiaries. In such a circumstance, if the parent of the selling subsidiary does not pay a fair allocation of the purchase price to the selling subsidiary, creditors of the selling subsidiary may challenge the transaction as fraudulent. The selling subsidiary conveyed assets, but received nothing in exchange -- no assets at all. Thus, the transfer of assets by the subsidiary to the buyer was not supported by reasonably equivalent value. And if the selling subsidiary transferred all or substantially all of its assets, receiving nothing in exchange, it may well have been rendered insolvent by the transaction. The purchaser should take care to pay reasonable value to each selling company in the corporate family, based on the value of the specific assets sold by each company.

Companies purchasing assets from distressed companies -- and their counsel -- should consider valuation issues in negotiating and structuring the transaction with potential fraudulent conveyance issues in mind. While there is no fail-safe formula for eliminating fraudulent conveyance risk, it is certainly a risk that can be managed.

Steven S. Scholes is a partner in the law firm of McDermott Will & Emery. He is the head of the firm's Chicago trial department, chairman of the Securities and Exchange Commission defense group and leader of the subprime and credit markets litigation group. His email is sscholes@mwe.com.

AS FEATURED ON

The Deal
.com

TheDeal.com is published by The Deal LLC.
© Copyright 2009 The Deal LLC. The Copyright Act of 1976 prohibits the reproduction by any means of any portion of this publication except with the permission of the publisher.

WWW.THEDEAL.COM