

Fall 2004

Creditors' Rights Risk: A Title Insurer's Perspective, 38 J. Marshall L. Rev. 223 (2004)

Paul L. Hammann

John C. Murray

Follow this and additional works at: <https://repository.law.uic.edu/lawreview>



Part of the [Banking and Finance Law Commons](#), [Bankruptcy Law Commons](#), [Business Organizations Law Commons](#), [Commercial Law Commons](#), [Consumer Protection Law Commons](#), [Contracts Commons](#), [Legislation Commons](#), [Litigation Commons](#), [Property Law and Real Estate Commons](#), and the [Secured Transactions Commons](#)

Recommended Citation

Paul L. Hammann & John C. Murray, Creditors' Rights Risk: A Title Insurer's Perspective, 38 J. Marshall L. Rev. 223 (2004)

<https://repository.law.uic.edu/lawreview/vol38/iss1/10>

This Symposium is brought to you for free and open access by UIC Law Open Access Repository. It has been accepted for inclusion in UIC Law Review by an authorized administrator of UIC Law Open Access Repository. For more information, please contact repository@jmls.edu.

CREDITORS' RIGHTS RISK: A TITLE INSURER'S PERSPECTIVE

PAUL L. HAMMANN* & JOHN C. MURRAY**

INTRODUCTION

The creditors' rights exclusion from title insurance coverage was introduced into owners' and lenders' title insurance policies more than a decade ago. The current version of the exclusion is found in paragraphs 4 and 7, respectively, of the 1992 American Land Title Association ("ALTA") Owner's and Loan Policy forms and will be referred to in this Article as the "creditors' rights exclusion." The risks addressed by the exclusion—fraudulent transfer, preferential transfer, and equitable subordination—will be referred to as "creditors' rights risk(s)."

The creditors' rights exclusion is intended to make clear that no coverage is afforded by a title insurance policy for post-policy challenges to the insured title or to the validity, enforceability, or priority of the lien of the insured mortgage arising solely out of the insured transaction (not one in the past chain of title), whereby the transfer to the insured owner or lender of its interest in the land is determined to be a fraudulent transfer or conveyance, or a preferential transfer, under either state or federal law. With respect to the Loan Policy only, the creditors' rights exclusion also confirms that no protection is provided to the insured lender if a post-policy challenge is made to the priority of the lien of the insured mortgage based on the bankruptcy doctrine of equitable subordination.

Some of those who work in the title insurance industry, as well as some who work for its customer groups, do not fully understand creditors' rights law and how to identify and address creditors' rights risks. Yet in the authors' experience the request

* Vice President, Underwriting Director and Senior Underwriting Counsel, First American Title Insurance Company, Santa Ana, California; B.A. 1976, University of Washington; J.D. 1979, University of Puget Sound (now Seattle University School of Law).

** Vice President and Special Counsel, First American Title Insurance Company, Chicago, Illinois; B.B.A. 1967, University of Michigan; J.D. 1969, University of Michigan. This Article contains the opinions and conclusions of the authors, and not necessarily those of their employer or the title insurance industry in general.

by the industry's customers to delete the creditors' rights exclusion, or to issue a form of title policy that does not contain the exclusion, has become a standard "check-list" item.¹ More recently, the industry has received requests to provide express creditors' rights coverage by endorsement.²

1. See John C. Murray, *Creditors' Rights Coverage for Lenders: Does Deletion of the Exclusion Imply Coverage?* (2003), at <http://www.firstam.com/faf/html/cust/jm-lendersrights.html> [hereinafter Murray, *Creditors' Rights*] (explaining the decision to exclude coverage for creditors' rights from title insurance).

2. On April 19, 2004, ALTA adopted Endorsement Form 21, which insures against loss under an Owner's or Loan Policy because of the occurrence, on or before the date of the policy, of a fraudulent transfer or preference under federal bankruptcy law or state insolvency or creditors' rights laws. Endorsement Form 21 provides as follows:

ENDORSEMENT
Attached to Policy No.

Issued by
BLANK TITLE INSURANCE COMPANY

The Company insures against loss or damage sustained by the insured by reason of the avoidance in whole or in part, or a court order providing some other remedy, based on the voidability of any estate, interest, or mortgage shown in Schedule A because of the occurrence on or before Date of Policy of a fraudulent transfer or a preference under federal bankruptcy, state insolvency or similar creditors' rights laws.

The coverage provided by this endorsement shall include the payment of costs, attorneys' fees and expenses necessary to defend the insured against those counts, and no others, of any litigation seeking a court order which will result in loss or damage against which this endorsement provides insurance to the extent provided in the Conditions and Stipulations.

This endorsement does not insure against loss or damage if the insured: (a) knew when it acquired any estate, interest, or mortgage shown in Schedule A that the transfer, conveyance, or mortgage was intended to hinder, delay, or defraud any creditor; or (b) is found by a court not to be a transferee or purchaser in good faith.

This endorsement is issued as part of the policy. Except as it expressly states, it does not (i) modify any of the terms and provisions of the policy, (ii) modify any prior endorsements, (iii) extend the Date of Policy, or (iv) increase the Amount of Insurance. To the extent a provision of the policy or a previous endorsement is inconsistent with an express provision of this endorsement, this endorsement controls. Otherwise, this endorsement is subject to all of the terms and provisions of the policy and of any prior endorsements.

[Witness clause optional]

BLANK TITLE INSURANCE COMPANY
BY:

This endorsement still must be specifically approved (which approval is, at

Under what conditions is it reasonable to expect the title insurer to agree to this "check-list" request to delete the creditors' rights exclusion? How, from an underwriting standpoint, should the title insurer analyze and evaluate this risk? Is creditors' rights just another basic transaction risk that is appropriately insurable with title insurance, or is it an inappropriate risk for a title insurer under certain circumstances—and if so, what are the circumstances that would cause a title insurer to refuse to assume the risk? This Article will attempt to provide the answers to these and other questions and provide a better understanding of the creditors' rights risk by discussing the factors considered by title insurers in identifying and underwriting the risk in connection with commercial real estate transactions.

I. PRE-CREDITORS' RIGHTS EXCLUSION

The creditors' rights exclusion was first inserted in the ALTA Owner's and Loan title insurance policies in 1990.³ Before that time, the industry relied on other policy exclusions for support of its general position that a title insurance policy does not provide coverage against fraudulent or preferential transfer claims arising out of the insured transaction, i.e., that someone may have a right to void a purchase or loan transaction because it was fraudulent as to creditors of the transferor (the seller in the case of a purchase transaction; the borrower in the case of a loan transaction), or preferred one creditor over other creditors.⁴

As a result of their experiences with leveraged buy-out transactions in the 1980s, title insurers learned that these other exclusions were not always sufficient to prevent them from becoming involved in a claim.⁵ This is because a title insurance policy provides dual protection to the insured: an obligation both to

best, uncertain) by those states that strictly regulate title insurance coverages, endorsements and rates (such as New York, New Mexico, Texas and Florida) before they become available for general use in those states.

3. See John C. Murray, *Title Insurance in Commercial Real Estate Transactions* (2000), at <http://www.firstam.com/faf/pdf/jmurray/commreal.pdf> [hereinafter Murray, *Title Insurance*] (explaining the demands and challenges of providing commercial title insurance).

4. These other exclusions are found in paragraphs 3(a), (b) and (d) of the Exclusions from Coverage section of the 1992 ALTA form Owner's and Loan policies, and exclude the following: (1) matters created, suffered, assumed or agreed to by the insured (paragraph 3(a)); (2) matters not known to the Company, not recorded in the public records at Date of Policy, but known to the insured claimant and not disclosed in writing to the Company by the insured claimant prior to the date the insured claimant became an insured (paragraph 3(b)); and (3) matters attaching or created subsequent to Date of Policy (paragraph 3(d)). See John C. Murray & James F. Karela, *The ATLA Standard Loan Policy*, ATTYS GUIDE TO TITLE INSURANCE (2000).

5. *Id.*

defend and to indemnify against loss.⁶ It has become clear, as a matter of general insurance law, that “an insurer’s duty to defend is broader than its duty to indemnify.”⁷ As a result, it is not uncommon for a title insurer to conclude that it must accept a tendered defense—and the attendant expense—even though there may be a legitimate basis for claiming that the policy does not afford coverage.

The costs of defense of a claim that a transfer is void or preferential can be substantial, and are often far greater than other types of title defenses because such claims, by their nature, can result in a total failure of title.⁸ Creditors’ rights claims also frequently require the services of expert witnesses and consultants (such as appraisers, accountants, financial analysts, and investment bankers) to testify in a subsequent bankruptcy proceeding with respect to determination of the following matters in connection with the challenged transaction: reasonably equivalent value, insolvency, unreasonably small capital, and ability to pay future debts as they come due.⁹

In an effort to clarify that neither defense nor indemnity coverage was being afforded in the Owner’s and Loan policies against the risk of creditors’ rights challenges based on elements present in the insured transaction, title insurers sought to take specific exceptions to coverage for these matters in Schedule B of title insurance policies issued in leveraged buyout transactions in the 1980s.¹⁰ The problem with this approach was that it required title personnel to recognize that the transaction was in fact a leveraged buyout or other structure that created a creditors’ rights risk. In order to recognize this risk, a title underwriter needed to (1) understand creditors’ rights law, (2) have sufficient facts about the nature and scope of the transaction, and (3) have sufficient time to analyze the facts in light of the applicable law.¹¹ It was a rare transaction where all of these elements were present. As a result, many transactions fraught with creditors’ rights risk “slipped through the cracks” without a Schedule B exception. When confronted with a claim, title insurers were forced to rely on the then existing policy exclusions and frequently incurred the

6. *Id.*

7. *Id.* See also *Pavarini v. Liberty Mut. Ins. Co.*, 270 A.D.2d 98, 99 (N.Y. App. Div. 2000) (“An insurer’s duty to defend is broader than the duty to indemnify and arises where the allegations of the complaint against the insured fall within the scope of risks undertaken by the insurer.”) (internal quotation marks and citations omitted).

8. Murray, *Title Insurance*, *supra* note 3.

9. See Murray, *Creditors’ Rights*, *supra* note 1 (explaining that bankruptcy cases can be the result of failure of title).

10. See generally *infra* notes 151-174 and accompanying text.

11. See Murray, *Title Insurance*, *supra* note 3 (explaining the duties of an underwriter).

expense of a costly defense.¹²

The title insurance industry did not consciously intend to insure against post-policy challenges to the title or to the lien of a mortgage based on the instant transfer being fraudulent or preferential to creditors of the transferor.¹³ If and when creditors' rights risk was recognized in pre-1990 transactions, the industry sought to obviate coverage with an appropriate Schedule B exception.¹⁴ In order to avoid inadvertently and unknowingly taking on this risk, even if that risk was only the cost of defense, the industry concluded that a pre-printed exclusion from coverage was necessary.¹⁵

II. THE CREDITORS' RIGHTS EXCLUSION

The initial language excluding coverage for creditors' rights claims was adopted by the ALTA in 1990 and was included in what became known as the 1990 ALTA Owner's and Loan Policies.¹⁶ "This language excluded claims arising out of the insured transaction by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws."¹⁷ The industry's customer groups objected to the breadth of this exclusion, believing that it excluded coverage for aspects of the insured transaction for which the insurer should, and intended to, provide coverage.¹⁸

For example, in most parts of the country it is the title insurer that accomplishes the recording of the title transfer and mortgage documents.¹⁹ This is a very valuable function provided by title insurers and serves to enhance the value of title insurance. If a bankruptcy case is filed by a seller or borrower before the deed or mortgage is recorded, the bankruptcy trustee or debtor-in-possession ("DIP"), having the rights of a hypothetical bona fide purchaser for value, likely will be successful in avoiding the interest of the transferee or mortgagee (the insured under a title

12. *Id.*

13. *Id.*

14. An exception for creditors' rights matters might read as follows:

Any right or asserted right of a creditor, trustee, or debtor in possession in bankruptcy to avoid that certain [conveyance] [mortgage] that was recorded on ____ in Book ____, Page ____, as Document No. _____ in the office of the Recorder of Deeds of _____ County, _____, pursuant to Title 11 of the United States Code (Bankruptcy) or any creditors' rights laws or insolvency law.

15. See Murray, *Creditors' Rights*, *supra* note 1.

16. *Id.*

17. *Id.*

18. See Murray, *Creditors' Rights*, *supra* note 1 (explaining how the 1990 Forms were thought to be "too broad and overreaching").

19. *Id.*

insurance policy).²⁰ The industry's customer groups were concerned that the 1990 creditors' rights exclusion would allow the insurer to deny coverage for an avoidance claim by a bankruptcy trustee or DIP even where the basis of the claim was solely the failure of the title insurer to timely record.²¹

The ALTA responded to these concerns by adopting in 1992, as a substitute for the 1990 creditors' rights exclusion, the following language:

[The following matters are expressly excluded from the coverage of this policy and the Company will not pay loss or damage, costs, attorneys' fees or expenses which arise by reason of:]

7. Any claim, which arises out of the transaction creating the interest of the mortgagee insured by this policy, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws, that is based on:

- (a) the transaction creating the interest of the insured mortgagee being deemed a fraudulent conveyance or fraudulent transfer; or
- (b) the subordination of the interest of the insured mortgagee as a result of the application of the doctrine of equitable subordination; or
- (c) the transaction creating the interest of the insured mortgagee being deemed a preferential transfer except where the preferential transfer results from the failure:
 - (i) to timely record the instrument of transfer; or
 - (ii) of such transfer to impart notice to a purchaser for value or judgment or lien creditor.²²

Thus, the current 1992 ALTA Owner's and Loan Policies exclude coverage for fraudulent- and preferential-transfer risk in the insured transaction that is not the result of the failure of the title insurer or its agent to timely record the instrument of transfer or the failure of recordation "to impart constructive notice to a purchaser for value or a judgment or lien creditor."²³ These

20. See *id.* (explaining the types of bankruptcy cases filed by a seller or borrower).

21. This view was shared, in a 1991 Memorandum from the New York State Department of Insurance, Title Insurance Memorandum Decision & Opinion 6 (Nov. 19, 1991) (on file with author), which stated: "[W]e are persuaded that the proposed creditors' rights exclusion [the 1990 version] is unnecessarily overbroad in language and, as such, could effectively carve-out traditional title insurance responsibilities as to even mundane credit-related issues."

22. See Murray, *Creditors' Rights*, *supra* note 1 (alteration in original) (quoting 1992 ALTA Loan Policy Exclusion from Coverage 7). The counterpart language from the 1992 ALTA Owner's Policy (adopted by the ALTA, along with the Loan Policy, on October 17, 1992), which is found in Paragraph 4 of the Exclusions from Coverage, is identical except for minor differences in the introductory language and the deletion of the reference to equitable subordination.

23. *Id.* While the phrase, "of the title insurer or its agent" does not appear in the language found in Exclusions 7(c) and 4(b) of the Loan and Owner's Policies, respectively, where the recording function is handled by the insured

"carve-outs" from the preference exclusion were designed to preserve coverage for preference challenges based on the failure of a title insurer to fulfill its "traditional" title insurance responsibilities.²⁴ In addition to addressing fraudulent- and preferential-transfer risk, the creditors' rights exclusion in the 1992 ALTA Loan Policy also specifically excludes any claim based on the subordination of the interest of the insured mortgagee as the result of equitable subordination.²⁵ The language of the 1992 creditors' rights exclusion, therefore, more specifically addresses the aspects of creditors' rights law of greatest concern to the title insurance industry and its customer groups.²⁶

Notwithstanding the reliance by title insurers on the standard exclusions in the older forms of ALTA policies described above, a serious question in title insurance underwriting in recent years has been whether the title insurer accepts the risk for losses due to creditors' rights challenges with respect to a policy that does not contain the creditors' rights exclusion. Lenders in particular argued that coverage for creditors' rights existed when a Loan Policy was issued with no creditors' rights exclusion.²⁷ They based this contention on the fact that the 1990 and 1992 ALTA Owner's and Loan Policies contain a preprinted creditors' rights exclusion, and that prior to the 1990 policies title insurers sometimes added special exclusions or exceptions for creditors' rights to certain title policies (when creditors' rights risk in the insured transaction was recognized).²⁸ Thus, they argued, a policy issued without a specific exclusion or exception for creditors' rights meant that the title insurer assumed the liability for these risks.²⁹

This issue was specifically addressed in *Chicago Title Insurance Co. v. Citizens and Southern National Bank*.³⁰ This case involved a claim against the title insurer under a pre-1990 ALTA Loan Policy for loss resulting from allegations by a bankruptcy trustee that the insured mortgages were preferential transfers.³¹ The court granted the title insurer's summary judgment motion,

or the insured's counsel and it is that party who fails to timely record, it is likely in the authors' opinion that any resulting preference claim could be denied by the title insurer as having been "created, suffered, assumed or agreed to" by the insured within the meaning of Exclusion from Coverage 3(a).

24. *Id.*

25. *Id.* See *infra* Part III-C for a discussion of the doctrine of equitable subordination.

26. See Murray, *Creditors' Rights*, *supra* note 1.

27. *Id.*

28. *Id.*

29. *Id.*

30. 821 F. Supp. 1492 (N.D. Ga. 1993), *aff'd sub nom*, Chi. Title Ins. Co. v. Nationsbank, 20 F.3d 1175 (11th Cir. 1994).

31. *Id.* at 1495. The court noted that it could not definitely say that the conveyance of the security interests constituted a preferential transfer, because this issue was never resolved by the bankruptcy court. *Id.*

ruling that the lender's claim under the policy related to a post-policy matter because it arose upon the subsequent filing of the bankruptcy petition, not at or prior to the policy date, and therefore was subject to Exclusion from Coverage 3(d), which specifically excludes from coverage "[d]efects, liens, encumbrances, adverse claims or other matters . . . attaching or created subsequent to Date of Policy."³² The court noted that "although no court has squarely addressed the question . . . in essence, this matter is simply a construction of a title insurance contract."³³ The insured argued that because the title insurer had inserted specific language excluding coverage for creditors' rights matters in other policies, the absence of such language in the insured's policy in the instant case thereby implied coverage for the preference claim.³⁴ The court rejected this reasoning, finding that whether or not the mortgages constituted preferential transfers (which was never resolved by the bankruptcy court), no coverage would be available because the loss was caused solely by the mortgagor's subsequent decision to file bankruptcy within the ninety-day preference period, and the insured lender's post-policy decision to settle the preference action with the mortgagor.³⁵

The court also recognized the lender's ability to monitor the ongoing financial status of the mortgagor, in contrast to the limited access of the title insurer to this information.³⁶ According to the court:

Sound legal policy would dictate that the [insured] should have borne this risk absent specific language to the contrary. . . . [T]he insured was in a far better position to determine possible future risks in extending further credit. Such risks would have included bankruptcy and an adverse action taken by the debtor-in-possession against its bank-creditor.³⁷

The court found that a title insurer's inclusion of a creditors' rights exclusion in other title policies does not create an implication that creditors' rights issues are not covered in policies that contain no such specific exclusion.³⁸ This is what title insurers had contended all along.³⁹

32. *Id.* at 1494.

33. *Id.*

34. *See id.* at 1495.

35. *Id.*

36. *Id.* at 1496.

37. *Citizens & Southern*, 821 F. Supp. at 1495.

38. *Id.*

39. *See also* *Ginger v. Am. Title Ins. Co.*, 185 N.W.2d 54, 55-56 (Mich. Ct. App. 1970) (denying title policy coverage for an alleged intentional fraudulent transfer on the basis that it involved material matters known to the insured and not disclosed to the title insurer); *Elysian Inv. Group v. Stewart Title Co.*, 105 Cal. App. 4th 315, 324 (2003) ("[The insured] cannot rely upon an exclusion to extend coverage."); *Ray v. Valley Forge Ins. Co.*, 77 Cal. App. 4th

The issue of coverage in this area may involve an analysis of the "reasonable expectations" of the parties. Lenders usually are concerned about the removal of the creditors' rights exclusion in connection with foreclosures, deeds in lieu of foreclosure, modifications, and other loan workouts, as well as in connection with new lending, refinancing, and sales and acquisitions of loan portfolios.⁴⁰ Title insurers, on the other hand, are concerned about possible claims based on alleged fraudulent conveyances and preferential transfers by the borrower, and the risk of equitable subordination of all or a portion of the lender's claim against the borrower in the event of a subsequent bankruptcy filing by or against the borrower. As confirmed by the court in *Citizens and Southern*, a title insurer's area of expertise is in reviewing land title records, not in reviewing the borrower's financial records for evidence of its potential insolvency or in reviewing the actions of the lender for evidence of misconduct, overreaching, or unconscionable behavior that may lead to subordination of all or a portion of the lender's claim against the borrower.⁴¹

A. Appropriateness of the Exclusion

A bankruptcy trustee's challenge to a transfer or encumbrance of title to real property affects title in a very basic sense. The claim is that the transfer is void and that (1) in a sale or other title-transfer context, the grantee in the deed conveying

1039, 1048 (1999) ("Insurance policy exclusions do not extend coverage."); *Stanford Ranch, Inc. v. Maryland Cas. Co.*, 89 F.3d 618, 626-27 (9th Cir. 1996) ("[I]t is well established in California that an exclusion cannot act as an additional grant or extension of coverage."). *But see* *First Nat'l Bank & Trust Co. v. N.Y. Title Ins. Co.*, 12 N.Y.S.2d 703, 709 (N.Y. Sup. Ct. 1939) (finding that where the plaintiff obtained a mortgagee's policy of title insurance and the mortgage was declared invalid as a preference under the Bankruptcy Act, the defect was not created by the insured but by "operation of law" and that coverage for a preference claim was not excluded by the policy). The court held that "created" referred to some affirmative act on the part of the insured bank other than the taking of the mortgage, and that the word "suffered," being synonymous with "permit," implied the power to prohibit or prevent and included knowledge of what was to be done with the intention that it be done. *Id.* at 709. Therefore, according to the court, since the bankruptcy court did not find any actual intent on the part of the bank to obtain a preference the defect had not been "suffered" by the bank. *Id.* But this reasoning by the court was probably dictum, because the court dismissed the bank's complaint on the separate grounds that it made several misrepresentations and concealed material facts with regard to its past financial relationship with the debtor and its knowledge about the value of the property. *Id.* at 715. *See also* *Denny's Rests., Inc. v. Sec. Union Title Ins. Co.*, 859 P.2d 619, 627-28 (Wash. Ct. App. 1993) ("Logically, a deleted exclusion indicates that the former exclusion is no longer applicable; any other result would undermine the rationale for paying additional consideration to obtain extended coverage.").

40. *Id.*

41. *Id.*

title is not the true owner or, (2) in a loan context, the lender's mortgage is invalid and unenforceable.⁴² The basis for such a challenge under either the Bankruptcy Code ("Code") or state fraudulent transfer or fraudulent conveyance statutes usually concerns the amount of consideration paid by the transferee or the financial position (i.e., the solvency) of the transferor.⁴³

The majority of title insurance personnel do not possess the knowledge and experience required to perform the detailed financial analysis often involved in analyzing creditors' rights issues.⁴⁴ Therefore, the creditors' rights exclusion was developed to protect title insurers from inadvertently insuring against creditors' rights risk in the subject transaction where the applicable facts and law did not justify coverage for the risk.

B. Limitation of the Exclusion

Both the 1990 creditors' rights exclusion and the 1992 modification exclude coverage only with respect to claims arising out of the specific transaction in which the insured buyer or lender acquires its interest. The exclusion thus affords only limited protection to the title insurer (i.e. it does not exclude coverage for fraudulent or preferential transfer claims arising out of *prior* transactions).⁴⁵ Stated another way, the ALTA Owner's and Loan

42. See Murray, *Title Insurance*, *supra* note 3, at iv (noting that failure of title can result in total loss of property).

43. *Id.* at xv-xvii.

44. See generally Murray, *Title Insurance*, *supra* note 3 (showing the financial and legal complexity of creditor's rights issues in this field). This has been recognized by the few states that do not allow a form of title insurance policy that does not contain a creditors' rights exclusion. For example, as stated by the New York Department of Insurance:

[T]he Insurance Department has determined that a creditors' rights exclusion is appropriate and should be included in title insurance policies. *Title insurance was never intended to cover these phenomena.* Unrequited creditors of a real estate seller or buyer should not be able to claim against title insurance. The risks may well be real that one or more parties to a real estate transaction might be or might become bankrupt or otherwise financially disabled, possibly transforming the transfer into a fraudulent conveyance or making its validity susceptible to attack as preferential. However, *risks of this nature are basically outside the purpose and scope of title insurance and, as a practical matter, fall beyond the competence of title insurance underwriters, who lack the expertise as well as timely, complete information, to gainsay.*

New York State Department of Insurance, *supra* note 21 (emphasis added).

45. See Murray, *Title Insurance*, *supra* note 3, at ix, xiii (discussing Schedule B exceptions). Regarding equitable subordination claims in a Loan Policy context, it is the authors' opinion that Exclusion from Coverage 3(a) for matters "created, suffered, assumed or agreed to by the insured claimant" will apply to these claims because, to be successful, a plaintiff seeking to subordinate a lender's security interest must prove that the lender was guilty of misconduct or overreaching. This point will be developed more fully in the section discussing equitable subordination below.

policies (absent a specific Schedule B exception) afford both defense and indemnity coverage for creditors' rights risk arising out of prior transactions in the chain of title (at least those with no direct connection to the insured transaction). The title industry recognizes the value and importance of this coverage to its customer groups.⁴⁶

Many transactions where creditors' rights issues are present—and many in which no such issues appear to be present—are preceded by transactions involving transfers of title or mortgage loans that may themselves be fraudulent or preferential. This increases the challenge and the risk to title insurers because of the need, when analyzing potential creditors' rights issues, to consider previous transactions, especially if they are in recent proximity and closely related to the transaction being insured. The closeness of such transactions increases the risk that a court will subsequently “collapse” the related transactions into one overall transaction.⁴⁷

C. Response to the Exclusion

In response to the creditors' rights exclusion, customers began requesting either the earlier ALTA policy forms that did not contain the exclusion, or the 1990 or 1992 ALTA forms with an endorsement deleting the creditors' rights exclusion.⁴⁸ From an underwriting perspective this request triggers a detailed analysis by the title insurer so that it can make a determination as to whether a creditors' rights issue exists in connection with the subject transaction. This analysis requires a working knowledge of creditors' rights law as well as the facts of the transaction. It involves a review and analysis of transaction documents and may involve review of financial data regarding the seller or borrower, as well as discussions with the parties to the transaction and/or their legal and financial representatives.

III. CREDITORS' RIGHTS LAW

The starting point for an analysis of creditors' rights issues is a review of the applicable federal and state statutes and case law relating to fraudulent conveyances and transfers, preferences, and equitable subordination. Once the law is understood, identifying creditors' rights issues becomes a matter of applying the law to the

46. Additionally, it is also possible for the insured to have actual knowledge of the facts and details of the prior transaction so that the risk of a fraudulent or preferential transfer challenge arising out of the prior transaction was “known to the insured claimant and not disclosed in writing to the [insurer] by the insured claimant,” within the meaning of Exclusion from Coverage 3(b).

47. See *infra* note 163 and accompanying text (explaining that such transactions may be viewed by a court as fraudulent).

48. See Murray, *Title Insurance*, *supra* note 3, at xiii-xiv, xxxvii.

facts of a particular transaction. To do so the title underwriter must be aware of and fully understand the relevant facts, which in turn necessitates an understanding of the structure of the transaction and of any other transactions of which the subject transaction is a part. This information may not be volunteered—not because the parties or their counsel are trying to keep it from the title insurer, but because the insured (or the insured's counsel) may not realize that such information is required to properly evaluate the request to delete the creditors' rights exclusion or provide express creditors' rights coverage. As a result, it often falls to the title insurer to seek this information. The earlier this information is made available to the title insurer before the closing date, the less of a chance there is for a delay of the closing and the less risk there is of an erroneous or adverse underwriting determination.

A. *Fraudulent Conveyances and Transfers*

Exclusion 7 in the ALTA Loan Policy deals with fraudulent transfers or conveyances.⁴⁹ A debtor may convey or transfer assets before the bankruptcy filing, often to relatives or related entities, in order to prefer such transferees over other creditors or to protect those assets from being included in the debtor's estate and, therefore, subject to the claims of other creditors. Alternatively the debtor may harm creditors by incurring additional obligations, e.g., by fraudulently placing a mortgage on his or her property to the detriment of other creditors. Section 548 of the Code provides the bankruptcy trustee the ability and authority to avoid such "fraudulent transfers."⁵⁰ The policy underlying § 548 is to protect creditors against the depletion of a bankruptcy estate by granting the trustee the power to set aside fraudulent transfers of the debtor's interests in property taking place within one year before the bankruptcy petition was filed.⁵¹

Section 548 is derived from the Statute of 13 Elizabeth passed

49. *Id.* at xiii.

50. 11 U.S.C. § 548 (2000). See *Max Sugarman Funeral Home, Inc. v. A.D.B. Investors*, 926 F.2d 1248, 1254 (1st Cir. 1991) ("The transfer of any interest in the property of a debtor, within one year of the filing of a petition in bankruptcy, is voidable by the trustee in bankruptcy if the purpose of the transfer was to prevent creditors from obtaining satisfaction of their claims against the debtor by removing property from their reach.")

51. See *Glinka v. Bank of Vt. (In re Kelton Motors, Inc.)*, 130 B.R. 170, 176-77 (Bankr. D. Vt. 1991) (tracing current fraudulent transfer laws to "a long line of fraudulent conveyance laws extending over two thousand years to at least early Roman law" and noting that the policy early on has been "to benefit the public at large by facilitating and encouraging the payment of just debts"); *Leibowitz v. Parkway Bank & Trust Co. (In re Image Worldwide, Ltd.)*, 139 F.3d 574, 577 (7th Cir. 1998) ("The fraudulent transfer statute, 11 U.S.C. § 548, contains a one year statute of limitations.")

by the English Parliament in 1571.⁵² Statute of 13 Elizabeth “was aimed at a practice by which overburdened debtors placed their assets in friendly hands thereby frustrating creditors’ attempts to satisfy their claims against the debtor.”⁵³

Section 101(54) of the Code defines “transfer” 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 and foreclosure of the debtor’s equity of redemption.”⁵⁴ The date of transfer, for fraudulent conveyance purposes, is the date on which the transfer would have become perfected against a subsequent bona fide purchaser under applicable state law.⁵⁵ A debtor may make a “transfer” by, among other things, incurring a debt or obligation, providing a guaranty, making a payment, granting a lien or security interest on its assets, or transferring all or a portion of its property.⁵⁶

Section 548 applies not only to transfers made by the debtor within one year before the commencement of the bankruptcy case,

52. 13 Eliz., c. 5 (1571) (Eng.). See also *Mellon Bank, N.A. v. Metro Comm., Inc.*, 945 F.2d 635, 644-45 (3d Cir. 1991), (explaining the “ancient roots” of § 548).

53. *Mellon Bank*, 945 F.2d at 644-45. Under Statute of 13 Elizabeth, a transfer could only be avoided if the debtor acted with actual intent to defraud. Because it was difficult to prove the debtor’s intent, the Statute was judicially expanded to prohibit transactions where the trustor would demonstrate an “implied” intent to defraud creditors. See generally *Glinka*, 130 B.R. at 177-78 (explaining the application of Statute 13 of Elizabeth in United States courts and stating that § 548 is a “descendant” of that statute); *Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488, 499 (Bankr. N.D. Ill. 1988) (“Modern fraudulent conveyance law derives from the English Statute of Elizabeth enacted in 1570 [sic], the substance of which has been either enacted in American statutes prohibiting such transactions or has been incorporated into American law as a part of the English common law heritage.”); *Field v. United States (In re Abatement Env'tl. Res., Inc.)*, No. 03-1771, 2004 U.S. App. LEXIS 11696 (4th Cir. June 15, 2004), at *9 (pointing out that “fraudulent conveyance law has its origins in the Statute of 13 Elizabeth, c. 5 (1571),” and that “[t]he purpose of the fraudulent conveyance doctrine is to prevent assets from being transferred away from a debtor in exchange for less than fair value, leaving a lack of funds to compensate the creditors”); Douglas Baird and Thomas A. Jackson, *Conveyance Law and its Proper Domain*, 38 VAND. L. REV. 829, 830 (1985) (“A debtor cannot manipulate his affairs in order to shortchange his creditors and pocket the difference. Those who collude with a debtor in these transactions are not protected either.”).

54. 11 U.S.C. § 101(54). See generally *Barnhill v. Johnson*, 503 U.S. 393, 400 (1992) (“We acknowledge that § 101(54) adopts an expansive definition of transfer.”).

55. 11 U.S.C. § 548(d)(1). See *Sandoz v. Bennett (In re Emerald Oil Co.)*, 807 F.2d 1234, 1237 (5th Cir. 1987); *Breeden v. L.J. Bridge Fund, LLC (In re Bennett Funding Group, Inc.)*, 232 B.R. 565, 570-71 (Bankr. N.D.N.Y. 1999).

56. 11 U.S.C. §§ 101(54), 548(d)(1).

but also incorporates state fraudulent conveyance statutes.⁵⁷ Both state laws and the Code contain provisions that make transfers under certain circumstances void as to creditors of the transferor (i.e., the seller in the case of a sale transaction and the borrower in the case of a loan transaction).⁵⁸ A transfer would violate these laws, and may be voided by the trustee or DIP, if it is either intentionally fraudulent or constructively fraudulent as to the transferor's creditors.⁵⁹

1. State Fraudulent Transfer Law

In 1918, the National Conference of Commissioners on Uniform State Laws ("NCCUSL") proposed adoption of the Uniform Fraudulent Conveyance Act ("UFCA"). The purpose of the UFCA, which was eventually adopted in twenty-six states, was to supersede the Statute of 13 Elizabeth, which provided that any transfer made for the purpose of hindering, delaying, or defrauding creditors is illegal and void.⁶⁰ "In 1984, [the UFCA] was revised and renamed the Uniform Fraudulent Transfer Act ("UFTA")."⁶¹ The UFTA is a "modernized" version of the UFCA, and has been enacted in forty states and the District of Columbia.⁶² The UFTA was adopted in order to address changes

57. Section 544(b) allows the trustee to stand in the shoes of an existing unsecured creditor and permits the trustee to bring state-law fraudulent conveyance or fraudulent transfer actions that such a creditor could bring.

58. 11 U.S.C. § 548(a)(1).

59. *Id.*

60. 13 Eliz., c. 5 (1571). See *Glinka*, 130 B.R. at 177 (noting that "[t]he Statute of Elizabeth has . . . served as the model for common law and modern American fraudulent conveyance laws") (citation omitted). "In 1938, the drafters of the Bankruptcy Act, in § 67(d), incorporated the essential provisions of the UFCA because it 'was deemed to be declaratory of the better decisions of American state courts construing the Statute of Elizabeth and because, it was believed, it would promote uniformity under the Bankruptcy Act with respect to the subject of fraudulent conveyances.'" *Id.* at 178 (quoting 4 COLLIER ON BANKRUPTCY ¶ 67.29, at 482 (14th ed. Supp. 1988)). Additionally, Congress clearly intended that § 548 of the Code, which replaced section 67(d) of the Bankruptcy Act, incorporate the substantive provisions of section 67(d) and its predecessor, the Statute of 13 Elizabeth. See *id.*; H.R. REP. NO. 95-595, at 375 (1977).

61. UFTA § 1 (2004). For an excellent discussion and analysis of both the UFCA and the UFTA, see Baxter Dunaway, *Law of Fraudulent Transfers*, in THE LAW OF DISTRESSED REAL ESTATE ch. 23 (2004) (including, as appendixes, the full text of the UFCA and the UFTA).

62. Only four states have retained the UFCA: Maryland, New York, Tennessee, and Wyoming. See generally *Lawson v. Barden (In re Skalski)*, 257 B.R. 707 (W.D.N.Y. 2001) (applying UFCA to a New York state fraudulent transfer claim); *Smith, Keller & Assocs. v. Dorr & Assocs.*, 875 P.2d 1258 (Wyo. 1994) (utilizing elements of UFCA for a Wyoming state claim). See also Bruce A. Markell, *Following Zaretsky: Fraudulent Transfers and Unfair Risk*, 75 AM. BANKR. L.J. 317, 332 (mentioning Maryland, New York, Tennessee and Wyoming as the only four states that have retained the UFCA).

in bankruptcy law (especially in the area of fraudulent transfers) and debtor-creditor relations in general.

Fraudulent conveyance challenges may occur under the UFCA or the UFTA because § 544(a) of the Code gives the DIP or the trustee the status of a hypothetical lien creditor whose lien was perfected as of the date of the filing of the bankruptcy petition.⁶³ Section 544(b)(1) incorporates state law into the bankruptcy process and enables the trustee or DIP to exercise the rights of creditors under state fraudulent transfer laws⁶⁴ to void any transfer of an interest of the debtor in property that is avoidable under applicable state law.⁶⁵

If another creditor who claims a lien against the applicable property has not properly perfected its lien as of the filing of the bankruptcy petition, the trustee or DIP can void that creditor's lien.⁶⁶ That creditor then becomes merely a general creditor of the bankruptcy estate. The purpose of § 544 is to arm the trustee with sufficient powers to acquire and evaluate all of the estate's property.⁶⁷

Similar to § 544(c) of the Code, the UFTA contains a "good faith" exception to the avoidability of fraudulent conveyances.⁶⁸ Under this exception, an objective inquiry notice standard will be applied to determine good faith.⁶⁹ The UFCA does not contain an

63. 11 U.S.C. § 544(a). See *Paramount Int'l v. First Midwest Bank, N.A.*, (In re *Paramount Int'l*), 154 B.R. 712, 714 (Bankr. N.D. Ill. 1993); *May v. Brown* (In re *May*), 19 B.R. 655, 658 (Bankr. N.D. Fla. 1982).

64. 11 U.S.C. § 544(b)(1).

65. *Id.* § 544(a). The trustee may exercise the rights of a hypothetical creditor even though the trustee has actual knowledge of the transfer. See *Pereira v. Ruggerite, Inc.*, No. 03 Civ. 1071, 2004 U.S. Dist. LEXIS 2546, at *15 (S.D.N.Y. Feb. 19, 2004) ("[N]o regard is paid to any actual knowledge of the trustee in determining whether the trustee may assume bona fide purchaser status.").

66. 11 U.S.C. § 544(a). Under § 544, the trustee has the power, as of the commencement of the bankruptcy case, to avoid transfers and obligations of the debtor to the same extent as certain hypothetical creditors. In accordance with § 544, the trustee has "the same avoidance powers as: (1) a judicial lien creditor; (2) a creditor holding an execution returned unsatisfied; or (3) a bona fide purchaser of real property, whether or not such creditors or purchaser exist." *PM Denver, Inc. v. Porter* (In re *Porter McLeod, Inc.*), 231 B.R. 786, 792 (Bankr. D. Colo. 1999).

67. 11 U.S.C. § 544(a). Only the bankruptcy trustee or the DIP (and not an unsecured creditor) has the right to enforce the remedies available. See *Bruce H. White & William L. Medford, Avoidance Powers Under § 544 of the Bankruptcy Code: In Whose Shoes Are You Standing?* 20 AM. BANKR. INST. J. 16 (2003) (discussing rights and remedies of trustee or DIP available under § 544, and noting that trustee or DIP has no standing to pursue parties on behalf of specific individual creditors).

68. UFTA § 8(a) (2004).

69. "Good faith" is not defined in the Code. See *Plotkin v. Pomona Valley Imports* (In re *Cohen*), 199 B.R. 709, 716 (B.A.P. 9th Cir. 1996) (using objective inquiry notice in application of good faith); *Howard N. Gorney & Lee*

exception for a "good faith" transfer, but provides that "fair consideration" must be given for the property.⁷⁰

Under § 548(a)(1) of the Code, the trustee or DIP can "reach back" one year before the filing of the bankruptcy petition, and seek to avoid as fraudulent any transfer made or obligation incurred by the debtor within that year.⁷¹ However, state fraudulent conveyance statutes do not require that the transfer be made within one year before the filing of the bankruptcy petition because the action is independent of bankruptcy.⁷² If the trustee or DIP elects to proceed under state fraudulent conveyance laws, state statutes of limitation control.⁷³ The UFTA contains its own statute of limitations which extinguishes any claim not brought "within four years after the transfer was made or the obligation was incurred," unless the fraud was intentional and was not discovered until a later time, in which event the limitations period is extended for an additional year after such discovery "was or could reasonably have been discovered by the claimant."⁷⁴ In at least one state, the limitation period is six years.⁷⁵ The UFCA does not specify a statute of limitations, and therefore the limitations period is left to individual state law. Limitations

Harrington, *The Importance of Good Faith in Fraudulent Transfer Analysis*, 22 AM. BANKR. INST. J. 30 (2003) (discussing the good faith exception to avoidability under § 548(c) and § 550(b)).

70. UFCA § 9(1) (2004). See also Stuart M. Brown & Jane M. Leamy, *The Scope of the Good Faith Exception to the Avoidability of Fraudulent Transfers*, American Bankruptcy Institute, Annual Spring Meeting, Washington, D.C., April 30-May 3, 1998 (discussing the applicability of the good faith defense under the UFTA, the UFCA, and § 548 of the Code).

71. 11 U.S.C. § 548(a)(1).

72. See *Hayes v. Palm Seedlings Partners (In re Agric. Research & Tech. Group, Inc.)*, 916 F.2d 528, 534 (9th Cir. 1990); *Martino v. Edison Worldwide Capital (In re Randy)*, 189 B.R. 425, 443 (Bankr. N.D. Ill. 1995). Section 1(12) of the UFTA contains a definition of "transfer" similar to § 101(54) of the Code, including "disposing of or parting with an asset or an interest in an asset, and includes payment of money, release, lease, and creation of a lien or other encumbrance." Section 8(d) of the UFCA contains a broad definition of "conveyance," which includes "every payment of money, assignment, release, transfer, lease, mortgage, or pledge of tangible or intangible property, and also the creation of any lien or incumbrance."

73. See, e.g., *In re Agric. Research & Tech Group, Inc.*, 916 F.2d at 534 (applying Hawaii state law rather than bankruptcy code); *Martino*, 189 B.R. at 443 (applying Illinois state fraudulent conveyance laws).

74. UFTA § 9(a). A bankruptcy trustee or DIP may be able to maintain a common law action to set aside a fraudulent transfer, even if the applicable UFTA statute of limitations has expired. See *Fleet Nat'l Bank v. Valente (In re Valente)*, 360 F.3d 256, 261 (1st Cir. 2004) (granting common law remedy to defrauded creditor where UFTA statute of limitations had expired, and stating that, "the UFTA did not preempt the field of equitable recovery for fraudulent transfers").

75. See *Orr v. Kinderhill Corp.*, 991 F.2d 31, 35 (2d Cir. 1993) (applying a six-year limitation under New York law).

periods are typically three to four years in states that have either adopted the UFCA or have their own version of a fraudulent-transfer statute.⁷⁶

Because of the ability of the trustee or DIP to "stand in the shoes of" a creditor and utilize state fraudulent transfer law pursuant to § 544(b) of the Code, the potential "reach back" period for fraudulent transfers is at least four years prior to a bankruptcy filing.⁷⁷ Also, under § 108(a) of the Code, the trustee or DIP has two years after commencement of a bankruptcy case within which to commence an avoidance action where the applicable statute of limitations had not expired as of the filing of the bankruptcy petition.⁷⁸ This has the effect of extending the statute of limitations for fraudulent transfer challenges under state law to at least six years from the time of the sale or loan closing, where a bankruptcy petition is filed by or on behalf of the transferor prior to the expiration of four years from the transfer date.⁷⁹ Section 546(a) of the Code requires that an action to avoid a fraudulent transfer under § 548 be commenced within two years after an order for relief, or one year after a trustee is appointed or the case is closed or dismissed.⁸⁰

As noted above, under the UFTA, an action to void a transfer as "intentionally fraudulent" must be commenced "within four years after the transfer was made or the obligation was incurred or, if later, within one year after the transfer or obligation was or could reasonably have been discovered by the claimant."⁸¹ In the case of "constructively fraudulent" transfers, there is no "discovery rule," so the UFTA's statute of limitation is "within four years after the transfer was made or the obligation was incurred."⁸² In

76. See *Lawson*, 257 B.R. at 709 (stating "[t]he statute of limitations for objecting to a fraudulent transfer under New York law is six years. . .").

77. 11 U.S.C. § 544(a)(1).

78. *Id.* § 108(a).

79. See *Orr v. Bernstein (In re Bernstein)*, 259 B.R. 555, 559-60 (Bankr. D.N.J. 2001) (holding that even though New Jersey's UFTA four-year statute of limitations had expired, the trustee could prosecute an action for fraudulent conveyance under § 544(b) because he may have been able to prove that the unsecured creditor could have availed himself of the UFTA's one-year tolling provision).

80. 11 U.S.C. § 546(a).

81. UFTA § 9(a).

82. *Id.* § 9(b). See also *Bay State Milling Co. v. Martin*, No. 99 C 6796, 2001 U.S. Dist. LEXIS 3402, at *5 (N.D. Ill. Mar. 16, 2001) (noting that "[t]he Uniform Fraudulent Transfer Act indicates two types of fraudulent transfers, actual fraud and constructive fraud") (citations omitted). See *Bay State Milling Co. v. Martin (In re Martin)*, 145 B.R. 933, 946 (Bankr. N.D. Ill. 1992) (holding that actual fraud or "fraud in fact" under the UFTA results where the "debtor transfers property with the intent to hinder, delay, or defraud his creditors" and that constructive fraud or "fraud in law" "occurs when: (1) a voluntary gift is made; (2) there is an existing or contemplated indebtedness against the debtor; and (3) the debtor has failed to retain sufficient property to pay the

UFTA states, the “outside” limit for fraudulent transfer challenges under state law can be as long as seven years after the transfer was made or the obligation was incurred.⁸³

The usual remedy for a fraudulent conveyance is to void the transfer and recover the property or its value from the transferee.⁸⁴ A good faith purchaser for value is protected under the Code⁸⁵ (and under the UFTA)⁸⁶ to the extent of the value given for the transfer, and in such case the remedy would be for money damages for the lesser of the value of the asset transferred or the amount necessary to satisfy the claim of the creditor.⁸⁷

indebtedness”).

83. See CAL. CIV. CODE § 3439.09(c) (2003) (stating that the action must be brought “within seven years after the transfer was made or the obligation was incurred”). See also *Tiger v. Anderson*, 976 P.2d 308, 310 (Colo. Ct. App. 1998) (holding that possession of property is sufficient to “perfect” transfer of title and to commence running of the four-year statute of limitations under the UFTA).

84. See, e.g., *Julien J. Studley, Inc. v. Lefrak*, 412 N.Y.S.2d 901, 908 (N.Y. App. Div. 1979) (holding that a transfer of corporate assets to a stockholder in bad faith may be set aside and the transferee is liable as a constructive trustee); *United States v. Brown*, 820 F. Supp. 374, 382 (N.D. Ill. 1993) (holding that when a fraudulent conveyance is deemed void under UFTA § 4, “a creditor may set aside the transfer and may elect to recover either the property itself or its cash value in satisfaction of the debt”); *Pereira v. Checkmate Stereo & Elecs., Ltd. (In re Checkmate Stereo and Elecs., Ltd.)*, 9 B.R. 585, 625 (Bankr. E.D.N.Y. 1981) (“The trustee is entitled to recover for the benefit of the estate from the defendants the property [fraudulently] transferred or its value.”). Cf. *Dahar v. Jackson (In re Jackson)*, 318 B.R. 5, 27 (Bankr. D. N.H. 2004) (holding that although, generally, changes in the value of the transferred asset that occur subsequent to the transfer do not affect the amount of the creditor’s recovery, “New Hampshire courts had a long-standing tradition of making equitable adjustments to judgments when the fraudulent transfer finding was based on constructive fraud rather than actual fraud”).

85. 11 U.S.C. § 548(c). In assessing the “good faith transferee” defense under § 548(c), the most important consideration is the transferee’s state of mind. What level of knowledge is necessary, i.e., actual or constructive, and what duty of inquiry would some form of notice require? Whether a purchase is “for value” depends on what the transferee gave and is not measured from the perspective of the debtor, as would be the case under § 548(a)(1)(B)(i). See *Peltz v. Hatten*, 279 B.R. 710, 735 (D. Del. 2002), (stating that to the extent a transfer is voided as fraudulent, § 550(a) “allows the trustee to recover the property transferred or the value of such property from the initial transferee or any immediate of [sic] mediate transferee of the initial transferee”), *aff’d*, No. 02-2865, 2003 U.S. App. LEXIS 5842 (3d Cir. Mar. 25, 2003).

86. UFTA § 8(a).

87. *Id.* § 8(b). A creditor may have the right under the UFTA or UFCA to institute a fraudulent conveyance action. See, e.g., N.Y. CLS DR & CR, §§ 278(1)(a), 279(b) & (c) (2004) (discussing where conveyance is fraudulent as to creditor, creditor may, “as against any person except a purchaser for fair consideration without knowledge of fraud at time of purchase, or one who has derived title immediately or mediately from such a purchaser, have the conveyance set aside”). See also *FDIC v. Davis*, 733 F.2d 1083, 1085 (4th Cir. 1984) (“Once a bankruptcy case has been closed, creditors having unvoided

Both present and future creditors may recover under section 4(a)(2)(1) of the UFTA when a transfer occurs for less than reasonably equivalent value and the transfer results in the debtor's capital being unreasonably small in relation to the debtor's business or transaction. Present creditors (but not future creditors) may recover property under the UFTA when it is transferred by the debtor for less than reasonably equivalent value if the debtor is insolvent or is rendered insolvent by the transfer, or when the transfer is to an insider for a prior debt when the debtor is insolvent and the insider knew of the debtor's insolvency.⁸⁸

2. Intentional Fraud

To constitute a fraudulent transfer under § 548(a)(1)(A) of the Code, the transfer must be made with "actual intent to hinder, delay, or defraud a creditor."⁸⁹ The focus is on the actual intent of the transferor, not the adequacy of consideration or the solvency of the transferor. Proof of such intent is usually extremely difficult. As a result, actual intent to defraud need not be shown by direct evidence, but may be inferred from the circumstances (or "badges of fraud") surrounding the conveyance, including reckless disregard of the consequences of the transaction and the subsequent conduct of the parties.⁹⁰ Under § 548(a)(1)(A),

liens on fraudulently conveyed property can pursue their state law remedies independently of the trustee in bankruptcy."); *Klingman v. Levinson*, 158 B.R. 109, 113 (Bankr. N.D. Ill. 1993) ("Once a trustee's statutory time period has expired, an unsecured creditor can bring an action against a fraudulent transferee under state law provided the state statute of limitations has not yet expired.") (citation and internal quotations omitted); *In re Savino Oil & Heating Co.*, 91 B.R. 655, 657 (Bankr. E.D.N.Y. 1988) (holding that an individual creditor could only institute an action upon a showing of extraordinary circumstances).

88. UFTA § 5.

89. 11 U.S.C. § 548(a)(1)(A). Each of these three elements of fraudulent intent is distinct; any one may be sufficient to render the transaction fraudulent. See *Cuthill v. Greenmark LLC (In re World Vision Entm't, Inc.)*, 275 B.R. 641, 656 (Bankr. M.D. Fla. 2002) (adopting a "totality of circumstances" test and examining the elements of fraud surrounding the circumstances).

90. See, e.g., *United States v. Tabor Realty Corp.*, 803 F.2d 1288, 1304 (3d Cir. 1986) (stating that under Pennsylvania law, an intent to defraud may be inferred from knowledge by the transferor and transferee that a debtor will be unable to pay a creditor); *Moody v. Sec. Pac. Bus. Credit, Inc.*, 971 F.2d 1056, 1075 (3d Cir. 1992) (holding that fraud may be inferred from the circumstances of the transaction); *Joel v. Weber*, 166 A.D.2d 130, 137 (N.Y. App. Div. 1991) (holding that to sustain a fraud action, it is sufficient to show evidence that there was not a genuine belief in the truth of the representation); *Kelly v. Armstrong*, 206 F.3d 794, 798 (8th Cir. 2000) (once trustee demonstrates "confluence" of badges of fraud, presumption of fraudulent intent exists); *In re Frierdich*, 294 F.3d 864, 870 (7th Cir. 2002)

generally only the trustee or debtor can avoid an intentionally fraudulent transfer.⁹¹

The UFTA distinguishes between present and future creditors and specifies the types of transfers that are fraudulent in each case. A transfer made or an obligation incurred is fraudulent under the UFTA as to present *and* future creditors if the debtor-transferor “made the transfer or incurred the obligation with actual intent to hinder, delay or defraud any creditor” or “without receiving a reasonably equivalent value” and the debtor “intended to incur, or believed or reasonably should have believed that he [or

(presence of numerous badges of fraud supported finding of fraudulent transfer); 5 COLLIER ON BANKRUPTCY ¶ 548.04[2][a], at 548-25 (15th ed. Rev. 2002).

91. 11 U.S.C. § 548(a)(1)(A). Under certain circumstances, however, creditors may have derivative standing to bring an action to avoid a fraudulent transfer on behalf of the bankruptcy estate. In *Glinka v. Federal Plastics Mfg. (In re Housecraft Indus. USA, Inc.)*, 310 F.3d 64, 70 (2d Cir. 2002), the court held that a creditor could assert fraudulent transfer claims vested in the trustee if the trustee consents, and if the court finds that the action is in the best interest of the estate and is necessary and beneficial to the efficient resolution of the bankruptcy proceedings. See also *Cybergenics Corp. v. Chinery*, 330 F.3d 548, 580 (3d Cir. 2003) (suggesting that creditors' committees can be granted standing to sue derivatively to avoid fraudulent transfer when the trustee is “delinquent” in pursuing action on behalf of the estate); *Commodore Int'l v. Gould (In re Commodore Int'l Ltd.)*, 262 F.3d 96, 100 (2d Cir. 2001) (holding that creditors may be permitted to bring a derivative action to avoid fraudulent transfer where the DIP unreasonably fails to bring suit or consents); *Fogel v. Zell*, 221 F.3d 955, 965 (7th Cir. 2000) (ruling that if the trustee unjustifiably refuses a demand to bring action to enforce a colorable claim of a creditor, that creditor may obtain permission of the bankruptcy court to bring action in place of, and in name of, the trustee); *Valley Media, Inc. v. Cablevision Electronics Sys. Corp. (In re Valley Media, Inc.)*, No. 01-11353(PJW), 2003 Bankr. LEXIS 940, at *6-7 (Bankr. D. Del. Aug. 14, 2003) (“It seems to me that where, as here, a debtor’s counsel has a conflict of interest in pursuing an estate claim so that it is effectively disqualified from pursuing an action that is otherwise a colorable claim, the debtor (or a trustee) can be viewed as delinquent and the creditors committee should be authorized to pursue the cause of action.”); *Jefferson County Bd. of County Comm’rs v. Voinovich (In re The V Cos.)*, 292 B.R. 290, 296 (B.A.P. 6th Cir. 2003) (ruling that bankruptcy courts may authorize a party other than the trustee or DIP to pursue avoidance actions, and allowing a creditor to file a complaint under §§ 547 and 548 under certain conditions); *Canadian Pac. Forest Prods. v. J.D. Irving Ltd. (In re Gibson Group, Inc.)*, 66 F.3d 1436, 1446 (6th Cir. 1995) (holding that an individual creditor could maintain an action only when the trustee failed to do so); Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (*In re Exide Techs., Inc.*), 299 B.R. 732, 739 (Bankr. D. Del. 2003) (holding that creditors may prosecute actions for fraudulent transfers “so long as the (1) party has the consent of the debtor-in-possession and (2) the court finds that suit by the creditor is (a) in the best interest of the estate, and (b) is necessary and beneficial to the fair and efficient resolution of the bankruptcy proceedings”) (citation omitted). See also *In re Savino Oil & Heating Co.*, 91 B.R. at 657 (holding that an individual creditor could maintain an action if trustee failed to do so).

she] would incur, debts beyond his [or her] ability to pay as they became due.”⁹² Under the UFTA, creditors can avoid conveyances made and obligations incurred by a person “with actual intent, as distinguished from intent presumed in law, to hinder, delay or defraud either present or future creditors.”⁹³ It is clear, under each of these statutory schemes (as well as under § 548 of the Code), that both present *and* future creditors have the ability to avoid intentionally fraudulent transfers.⁹⁴ As noted earlier, the bankruptcy trustee or DIP can avoid any transfer made or obligation incurred with intent to “hinder, delay or defraud” any creditor.⁹⁵ Each of these “badges of fraud” is stated in the disjunctive; therefore, a creditor need only show one type of intent in order to succeed in proving that the transfer is “intentionally” fraudulent.⁹⁶

Among the factors that are considered in determining actual intent to hinder, delay, or defraud are the following:

- Was the transfer or obligation to an insider?
- Did the debtor retain possession or control of the property transferred after the transfer?
- Was the transfer or obligation disclosed or concealed?
- Had the debtor been sued, or threatened with suit, before the transfer was made or obligation incurred?
- Was the transfer of substantially all of the debtor's assets?
- Had the debtor removed or concealed assets?
- Was the value of the consideration received by the debtor reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred?
- Was the debtor insolvent at the time of, or did the debtor become insolvent shortly after, the transfer was made or the obligation incurred?
- Did the transfer occur before or shortly after a substantial debt was incurred?
- Had the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor?⁹⁷

92. UFTA § 4(a). *See also id.* § 4(b) (listing eleven factors to be considered in determining actual intent to defraud creditors). Although good faith of the transferee is not determinative of whether the consideration received is adequate, lack of good faith may be a basis for denying protection of a transferee or obligee under section 8 of the UFTA.

93. *Id.* § 4(a)(1).

94. *See id.* (noting that making transfers with the “actual intent to hinder, delay or defraud” is fraudulent).

95. *Id.*

96. *Id.*

97. *Id.* § 4(b). *See, e.g.,* Salomon v. Kaiser (*In re Kaiser*), 722 F.2d 1574, 1582-83 (2d Cir. 1983) (describing the “badges of fraud” to determine actual

A title insurer typically would not have knowledge of any of these indicators of intentional fraud. Many of these “badges of fraud” depend upon the state of mind of the parties involved.⁹⁸ Some involve conduct or activity subsequent to the date a transfer is made or an obligation is incurred and, therefore, after the date that the title insurer has issued, or become obligated to issue, its title policy.⁹⁹

This aspect of fraudulent transfer analysis begins with the following question: Is there any evidence that the seller or borrower is attempting in any way to hinder, delay, or defraud his, her, or its creditors? These elements are in the disjunctive, so it is only necessary to find one of them to evidence an intentionally fraudulent transfer. In this analysis, one looks for any “badges of fraud.”¹⁰⁰ For example, did the seller or borrower only recently receive title? If so, is there any evidence of a relationship between the seller or borrower in the current transaction and the transferor in the prior transaction? Is the transferee in the current transaction an “insider” of the transferor? Has the transferor recently incurred a substantial debt? Is there any litigation pending against the seller or borrower that could suggest a motivation to conceal assets?¹⁰¹

3. Constructive Fraud

While § 548(a) of the Code provides that the trustee cannot recover property as a fraudulent conveyance unless he or she can prove “actual intent” to hinder, delay, or defraud a creditor, § 548(a)(1)(B) allows the trustee, under an “implied fraud” analysis,

intent); *In re Brantz*, 106 B.R. 62, 67 (Bankr. E.D. Pa. 1989) (describing “badges of fraud” from which fraudulent intent may be inferred); *In re Sergio, Inc.*, 16 B.R. 898, 908 (Bankr. D. Hawaii 1981) (noting that fraud could be established by examining the purpose of each conveyance); *Haynes v. Holstein (In re Crescent Cmtys., Inc.)*, 298 B.R. 143, 149 (Bankr. S.D. Ohio 2003) (“Ohio law is very clear that ‘badges of fraud’ are circumstances so frequently attending fraudulent transfers, that the inference of fraud arises from them.”).

98. See *Kaiser*, 722 F.2d at 1582-83 (discussing examples of “badges of fraud”).

99. *Id.* If the insured purchaser or lender in fact had any knowledge of or involvement in the seller’s or borrower’s efforts to hinder, delay, or defraud its creditors, a claim against the title insurer likely will be denied. See ALTA *Loan Policy*, available at <http://www.alta.org/standards/index.cfm> (last visited Feb. 15, 2005) (stating that any such knowledge or involvement by the insured could be the basis of a claim denial as a matter “created, suffered, assumed or agreed to” under Exclusion 3(a) of the ALTA Owner’s and Loan policies).

100. See *Kaiser*, 722 F.2d at 1582-83.

101. Ordinarily, one would not expect a bona fide purchaser or lender to have any knowledge, or involvement in, a seller’s or borrower’s effort to hinder, delay, or defraud a creditor. But a title insurer nevertheless would be hesitant to delete the creditors’ rights exclusion if any of the facts suggested by the above analysis were present, because of the potential economic impact on the title insurer of a successful fraudulent transfer claim.

to recover transfers that were made under such suspicious circumstances that they are conclusively presumed to have been fraudulent without any proof of the debtor's subjective intent.¹⁰² Based on the different evidentiary tests set forth in §§ 548(a)(1)(A) and 548(a)(1)(B), bankruptcy courts have held that implied fraud under § 548(a)(1)(B) is subject to the "preponderance of the evidence" standard and not the more difficult "clear and convincing" standard applied to § 548(a)(1).¹⁰³

A defense to a fraudulent transfer claim is that the transferee gave value in good faith for the transfer.¹⁰⁴ The good faith defense applies to both actual and constructive fraud claims, and allows the transferee to obtain a lien or retain any interest transferred or enforce any obligation incurred to the extent of the value given.¹⁰⁵

102. 11 U.S.C. § 548(a)(1)(B). See *Glinka*, 130 B.R. at 178 (stating that under § 548(a)(1)(B) direct evidence of a fraudulent state of mind was not required); *In re Jackson*, 318 B.R. at 13 (finding that actual intent of debtor is "irrelevant" with respect to determination of constructive fraud under the UFTA); *Lewis v. Harlin (In re Harlin)*, No. 04-73358, 2005 U.S. Dist. LEXIS 1516, at *20 (E.D. Mich. Feb. 3, 2005) ("[T]he 'badges of fraud' apply only when considering a claim of actual fraud . . . not constructive fraud.").

103. See *Armstrong v. Ketterling (In re Anchorage Marina, Inc.)*, 93 B.R. 686, 691 (Bankr. D.N.D. 1988) (applying a preponderance of the evidence standard for implied fraud); *Zimmerman v. Savielloe (In re Metro Shippers, Inc.)*, 78 B.R. 747, 751 (Bankr. E.D. Pa. 1987) (explaining different standards for claims brought under §§ 548(a)(1)(A) and (a)(1)(B)); *Talbot v. Warner (In re Warner)*, 65 B.R. 512, 520 (Bankr. S.D. Ohio 1986) (defining standards for summary judgment under different claims of fraud); *Glinka*, 130 B.R. at 178 (noting that the movant must prove each element of implied fraud by a preponderance of the evidence); *In re Wilson Dairy Co.*, 30 B.R. 67, 70 (Bankr. S.D. Ohio 1983) (explaining that under § 548(a)(1)(B), the implied fraud section, each element must be proven); *In re Jackson*, 318 B.R. at 13 ("[U]nder UFTA, the Plaintiff must prove actual fraud by clear and convincing evidence and constructive fraud by a preponderance of the evidence.").

104. 11 U.S.C. § 548(c). The Code does not define "good faith."

105. *Id.* See, e.g., *Jobin v. McKay (In re M & L Bus. Machines)*, 84 F.3d 1330, 1338 (10th Cir. 1996) (noting that "if the circumstances would place a reasonable person on inquiry of a debtor's fraudulent purpose, and a diligent inquiry would have discovered the fraudulent purpose, then the transfer is fraudulent"); *Brown v. Third Nat'l Bank (In re Sherman)*, 67 F.3d 1348, 1355 (8th Cir. 1995) (noting that "a transferee does not act in good faith when he has sufficient knowledge to place him on inquiry notice of the debtor's possible insolvency"); *In re Agric. Research & Tech. Group*, 916 F.2d at 535-36 (holding that the objective good faith standard of what transferee "knew or should have known" applied in this case). See also *In re Practical Inv. Corp.*, 95 B.R. 935, 946 (Bankr. E.D. Va. 1989) (requiring actual knowledge under a claim brought under § 548(a)); *In re Indep. Clearing House Co.*, 77 B.R. 843, 862 (D. Utah 1987) (stating that "the test is whether the transaction in question bears the earmarks of an arm's length bargain"); *Jimmy Swaggart Ministries v. Hayes (In re Hannover Corp.)*, 310 F.3d 796, 800-01 (5th Cir. 2002) (declining to overturn the trial court's finding of good faith, and warning of "caution in attempting to propound a broad rule concerning 'good faith' for § 548(c)").

a. Reasonably Equivalent Value

Under the UFTA, a transfer made or obligation incurred “without receiving a reasonably equivalent value in exchange” may be fraudulent as to present and, under two of the three alternative financial tests, future creditors.¹⁰⁶ The UFCA, in its counterpart constructive-fraud provision, uses the language “without fair consideration” but also considers both present and future creditors.¹⁰⁷ Each of these statutes also requires that an additional element be present: either undercapitalization of the transferor or the incurrence of debts by the transferor beyond its ability to pay.¹⁰⁸

Under the UFTA, where the transfer is to an insider for an antecedent debt, only *present* creditors—i.e., those whose claims arose before the transfer—can avoid the transfer without regard to whether the transferor received reasonably equivalent value.¹⁰⁹ The creditor is only required to show that the transferor was insolvent at the time of the transfer and that the insider had reasonable cause to believe that the transferor was insolvent.¹¹⁰

A transfer is also deemed to be constructively fraudulent under § 548(a)(1)(B) of the Code, and may be avoided by the trustee or DIP if, within one year prior to the filing of the bankruptcy petition, the creditor receives “less than reasonably equivalent value” in a transaction *and* the transaction meets any one of the following requirements: (1) the transferor was insolvent at the time of the transfer or was rendered insolvent as the result of the transfer; (2) the transferor was undercapitalized at the time of the transfer or became undercapitalized as the result of the transfer; or (3) the transferor was unable or rendered unable by the transfer to pay its debts as they became due.¹¹¹ These tests are sometimes referred to as, respectively, the “insolvency test,” the “capitalization test,” and the “cash flow test.”¹¹²

106. UFTA § 4.

107. UFCA § 4. See *Peet Packing Co. v. McLain* (*In re Peet Packing Co.*), 233 B.R. 387, 390 (Bankr. E.D. Mich. 1999) (establishing under the Michigan UFCA “that a party to a transaction provided ‘fair consideration’ generally requires two findings: that the party acted in good faith; and that the values exchanged were for a fair equivalent”); *Lawson*, 257 B.R. at 711 (stating that “fair value is not sufficient [under the UFCA] if bad faith taints the transaction”); *Studley*, 66 A.D.2d at 214 (“Under the statute [New York UFCA] a creditor has standing to maintain an action to set aside a fraudulent transfer, though his debt may not have been in existence at the time of the transfer.”) (citations omitted).

108. UFCA §§ 5-6.

109. UFTA § 5(a).

110. *Id.* § 5(b).

111. 11 U.S.C. § 548(a)(1)(B)(ii)(I)–(III).

112. John C. Murray, *Guaranties and Fraudulent Transfers*, available at <http://www.firstam.com/faf/html/cust/jm-guaranties.html> (last visited Feb. 15, 2005) [hereinafter Murray, *Guaranties and Fraudulent Transfers*].

Upon avoidance of the transfer, the property would then be transferred back to the estate, subject to a lien for whatever price was paid for the asset.¹¹³ Inadequate consideration would not apply to sales at the market price that would generally benefit creditors, and therefore such sales would not be avoidable.¹¹⁴

"Reasonably equivalent value" and "fair consideration" are considered to have essentially the same meaning.¹¹⁵ "Reasonably equivalent value" is not defined in or explained in the Code, but has been determined by both federal and state courts on a case-by-case factual basis.¹¹⁶ Factors considered by the courts include (1) the good faith of the parties, (2) the difference between the amount paid and the fair market value, (3) the percentage of the fair market value paid, and (4) whether the transaction was arm's length.¹¹⁷

113. 11 U.S.C. § 548(a)(1)(B). Under the UFTA, a fraudulent transfer generally is deemed to be "voidable" with respect to a transfer of title to a good-faith transferee without notice of the fraud (who will receive good title to the property), but will be considered "void" in the limited sense that creditors may otherwise treat the transferred property as though the transfer had never been made. See, e.g., *In re Mortgage Am. Corp.*, 714 F.2d 1266, 1272-73 (5th Cir. 1983); *Baldwin v. Burton*, 850 P.2d 1188, 1192-93 (Utah 1993); *Assocs. Hous. Fin. L.L.C. v. Stredwick*, 83 P.3d 1032, 1036 (Wash. Ct. App. 2004).

114. *Murray, Guaranties and Fraudulent Transfers*, *supra* note 112.

115. *Id.*

116. *Id.* See also *In re Ozark Rest. Equip. Co.*, 850 F.2d 342, 344-45 (8th Cir. 1988) ("[R]easonably equivalent value is a means of determining if the debtor received a fair exchange in the market place for the goods transferred."); *Leonard v. Mylex Corp. (In re Northgate Computer Sys.)*, 240 B.R. 328, 365 (Bankr. D. Minn. 1999) ("The issue of the reasonable equivalence of value is a question of fact. The inquiry on this element is fundamentally one of common sense, measured against market reality.") (citation omitted). Reasonably equivalent value also may come in the form of an "indirect benefit" to the debtor, and if the transfer is otherwise in good faith it would not constitute a fraudulent transfer. See e.g., *Frontier Bank v. Brown (In re N. Merch., Inc.)*, 371 F.3d 1056, 1059-60 (9th Cir. 2004) (noting that the debtor's grant of a security interest to a bank lender that made a loan to the debtor's shareholders was not a fraudulent conveyance where the debtor received 100% of the benefit from the loan, resulting in no net loss to the debtor's estate or to funds available to unsecured creditors); *Harman v. First Am. Bank of Md. (In re Jeffery Bigelow Design Group, Inc.)*, 956 F.2d 479, 485 (4th Cir. 1992) ("[R]easonably equivalent value can come from one other than the recipient of the payments, a rule which has become known as the indirect benefit rule."); *In re Image Worldwide*, 139 F.3d at 578-79 (holding that indirect benefits may be considered when determining whether the guarantor received reasonably equivalent value for the guarantee).

117. See *In re Morris Communications NC, Inc.*, 914 F.2d 458, 467 (4th Cir. 1990); *Washington v. County of King William (In re Washington)*, 232 B.R. 340, 342 (Bankr. E.D. Va. 1999); *Boyd v. Sachs*, 153 B.R. 457, 498-99 (Bankr. W.D. Mich. 1993); *Webster v. Barbara (In re Otis & Edwards, P.C.)*, 115 B.R. 900, 909-10 (Bankr. E.D. Mich. 1990). See also *Mellon Bank, N.A. v. Official Comm. of Unsecured Creditors of R.M.L., Inc.*, 92 F.3d 139, 151 (3d Cir. 1996) ("[W]hen the debtor is a going concern and its realizable going concern value

However, in the case of forced sales (such as foreclosures), such factors may not be appropriate or determinative. The U.S. Supreme Court specifically addressed the issue of reasonably equivalent value in the context of a mortgage foreclosure sale in *BFP v. Resolution Trust Corp.*¹¹⁸ In *BFP*, the Court held that reasonably equivalent value, in the case of a mortgage foreclosure, is the price received at a regularly conducted, non-collusive foreclosure sale of the property as long as all the requirements of the State's foreclosure laws have been complied with.¹¹⁹ However, the Court was careful to note that its opinion applied only to real estate mortgage foreclosures and that "[t]he considerations bearing upon other foreclosures and forced sales (to satisfy tax liens, for example) may be different."¹²⁰ Thus, the Court's holding in *BFP* would not necessarily apply to non-judicial foreclosures or to certain other real estate transactions, such as deeds in lieu of foreclosure (where reasonably equivalent value for conveyance of the property must be established) or tax foreclosure sales.¹²¹

after the transaction is equal to or exceeds its going concern value before the transaction, reasonably equivalent value has been received."); *In re Ozark Rest. Equip. Co.*, 850 F.2d at 344 (holding that the reasonably equivalent value inquiry is only a factual one); *Leibowitz v. Parkway Bank & Trust Co.*, 210 B.R. 298, 301 (Bankr. N.D. Ill. 1997) (holding that determination of whether the debtor received reasonably equivalent value "turns on an analysis of the type [and] amount of [the] benefit obtained by Debtor in return for the transfers"), *affd. sum nom*, *In re Image Worldwide, Ltd.*, 139 F.3d 574 (7th Cir. 1998); *Heritage Bank Tinley Park v. Steinberg (In re Grabill)*, 121 B.R. 983, 994 (Bankr. N.D. Ill. 1990) (finding that whether a debtor received reasonably equivalent value is a comparison of "what went out" with "what was received"); *Joshua Slocum, Ltd. v. Boyle (In re Joshua Slocum, Ltd.)*, 103 B.R. 610, 618 (Bankr. E.D. Pa. 1989) ("[A]n exchange or obligation undertaken for reasonably equivalent value depends on the facts of each case."); *In re Exide Techs., Inc.*, 299 B.R. at 748 (noting that third circuit courts follow the "totality of circumstances" test for determining reasonably equivalent value, and that market value is an important component of the test, as well as the good faith of the parties, the difference between amount paid and fair market value, and whether the transaction was at arm's length).

118. 511 U.S. 531 (1994).

119. *Id.* at 536-37.

120. *Id.* at 537 n.3. Under the UFTA, a regularly conducted foreclosure sale is not a fraudulent transfer, regardless of the amount paid at the foreclosure sale to obtain the property. UFTA § 3(b) (providing that reasonably equivalent value exists in connection with "a regularly conducted non-collusive foreclosure sale or execution of a power of sale"). The UFCA does not specifically address the issue of whether a regularly conducted non-collusive foreclosure sale can be avoided as a fraudulent transfer.

121. See Federal Nat'l Mortgage Ass'n v. Fitzgerald (*In re Fitzgerald*), 237 B.R. 252, 266 (Bankr. D. Conn. 1999) [hereinafter *Fitzgerald I*] (holding that because Connecticut's strict foreclosure does not provide for public sale, the *BFP* decision, which applies only to properly conducted, non-collusive foreclosure sale, did not automatically control as to whether property had been transferred for reasonably equivalent value; accordingly, the court agreed to conduct further factual proceedings to ascertain the value of the property and

Several bankruptcy courts have applied the *BFP* holding to other forced-sale situations, such as judicial tax sales, and generally have upheld such sales upon a finding that the procedural and substantive rights of the debtor had been protected.¹²²

the mortgagee's claim); *Chorches v. Fleet Mortgage Corp.* (*In re Fitzgerald*), 255 B.R. 807, 810 (Bankr. D. Conn. 2000) [hereinafter *Fitzgerald II*] (reaffirming the court's rationale in *Fitzgerald I*, and finding that Connecticut made the legislative decision "not to accord a conclusive presumption of 'reasonably equivalent value' to strict foreclosures under state fraudulent transfer law"). *But see Talbot v. Fed. Home Loan Mortgage Corp.* (*In re Talbot*), 254 B.R. 63, 68-70 (Bankr. D. Conn. 2000) (holding that a judgment entered under Connecticut's strict foreclosure law conclusively established that "reasonably equivalent value" was received and precluded debtors from asserting that the foreclosure judgment was a constructively fraudulent transfer); *Chase Manhattan Mortgage Corp. v. St. Pierre* (*In re St. Pierre*), 295 B.R. 692, 698 (Bankr. D. Conn. 2003) (rejecting the debtors' argument that *BFP* does not apply to strict foreclosures, and stating that, "[t]here are no allegations that the debtors were denied their procedural rights or that there were irregularities in the foreclosure process").

122. *In re Washington*, 232 B.R. at 344 (finding a delinquent tax sale valid because the sale was held in strict accordance with state statutory requirements, which gave the delinquent taxpayer "more than adequate protection," including notice and opportunity to cure); *In re Samaniego*, 224 B.R. 154, 162 (Bankr. E.D. Wash. 1998) (holding that the sale was valid because the debtor's rights had been adequately protected); *Russell-Polk v. Bradley* (*In re Russell-Polk*), 200 B.R. 218, 221-22 (Bankr. E.D. Mo. 1996) (finding that the debtor was adequately protected); *T.F. Stone Co. v. Harper* (*In re T.F. Stone Co.*), 72 F.3d 466, 471 (5th Cir. 1995) ("That [the county's] sale to the [tax purchaser] was a tax sale rather than a mortgage foreclosure sale does not change the reality that it was a forced sale."); *Golden v. Mercer County Tax Claim Bureau* (*In re Golden*), 190 B.R. 52, 58 (Bankr. W.D. Pa. 1995) (holding that *BFP* applies to "regularly conducted tax sales"); *Hollar v. Myers* (*In re Hollar*), 184 B.R. 243, 252 (Bankr. M.D.N.C. 1995) (noting similarities of procedural safeguards, including the requirement under state statute for public notice and public auction); *Lord v. Neumann* (*In re Lord*), 179 B.R. 429, 434 (Bankr. E.D. Pa. 1995) (noting a requirement for competitive bidding under specific bidding procedures); *McGrath v. Simon* (*In re McGrath*), 170 B.R. 78, 82 (Bankr. D.N.J. 1994) (requirement for public notice of tax sale and procedures to encourage competitive bidding); *Comis v. Bromka* (*In re Comis*), 181 B.R. 145, 150 (Bankr. N.D.N.Y. 1994) ("The Bankruptcy Code is without authority to void a tax foreclosure sale conducted in accordance with state law."). However, other courts have ruled that a tax foreclosure sale, although conducted in accordance with state law, was invalid and constituted a fraudulent transfer. *See Sherman v. Rose*, 223 B.R. 555, 559 (B.A.P. 10th Cir. 1998) (ruling that *BFP* did not apply to a tax foreclosure sale where there was no opportunity for competitive bidding and \$450 paid for debtor's real estate at foreclosure was not "reasonably equivalent" value for property worth between \$10,000 and \$50,000); *Wentworth v. Town of Acton* (*In re Wentworth*), 221 B.R. 316, 319-20 (Bankr. D. Conn. 1998) (holding that a non-judicial tax foreclosure sale of a tax lien under statute without judicial oversight, competitive bidding, public notice, or public sale, with a one to thirteen ratio between the tax lien and property value, was not for reasonably equivalent value); *Dunbar v. Johnson* (*In re Grady*), 202 B.R. 120, 125 (Bankr. N.D. Iowa 1996) (holding that *BFP* does not apply to the forfeiture of a real

A creditors' rights issue exists, for title insurance underwriting purposes, under the constructive fraud provisions of state and federal fraudulent transfer laws, in every transaction in which a transfer is made and the seller-transferor (in the case of a transfer of title) or the borrower-transferor (in the case of a transfer of a mortgage lien) receives less than "reasonably equivalent value" or "fair consideration," or where there is a transfer to an insider.¹²³ Fortunately, reasonably equivalent value is likely to be present in the majority of transactions handled by the title insurance industry, and therefore the creditors' rights exclusion can safely be deleted in most transactions. This is because most real estate transactions involve arms-length sales between unrelated parties, each of whom is represented by independent professionals and either involve a straightforward purchase money mortgage or a refinancing transaction (i.e., new secured debt paying off existing secured debt when the same borrower owns the real estate security). Of course, even these "vanilla"¹²⁴ transactions can include an element of "intentional" fraud and may be susceptible to avoidance, as discussed above.

If a transfer is made for less than "reasonably equivalent value" or "fair consideration" and the purchaser or mortgagee requests that the title insurer issue a policy without the creditors' rights exclusion, the insurer will need to consider, as part of its underwriting analysis, whether the transferor is (1) insolvent, or rendered insolvent, at the time of the transfer, (2) engaged in a business or a transaction for which it has unreasonably small capital, or (3) about to incur debts beyond its ability to pay as they

estate contract under state law because "where no sale occurs, the only barometer to determine value is the amount of any debt remaining on the sale contract. This amount has no relationship to market forces . . . [and] could be minuscule and bear no relationship to reasonably equivalent value"); 40235 Wash. St. Corp. v. Lusardi, 177 F. Supp. 2d 1090, 1098 (S.D. Cal. 2001) (stating that "other considerations" prevented the court from extending *BFP* to a tax foreclosure sale), *aff'd on other grounds*, 329 F.3d 1076 (9th Cir. 2003). At least one court, considering the similarities in both the purpose language of § 548 of the Code and the fraudulent conveyance provisions of the UFTA, has applied the same "reasonably equivalent value" analysis under both laws to a tax foreclosure sale. See *Kojima v. Grandote Int'l L.L.C. (In re Grandote Country Club Co.)*, 252 F.3d 1146, 1152 (10th Cir. 2001) (noting that the transfer of real property was for reasonably equivalent value, and was not fraudulent under Colorado Uniform Fraudulent Transfer Act, where the defendant acquired the property through a regularly conducted tax sale under Colorado law subject to a competitive bidding procedure). See also Marie T. Reilly, *Making Sense of Successor Liability*, 31 HOFSTRA L. REV. 745, 763 n.85 (2003) ("Although courts interpreting the UFTA (including bankruptcy courts applying UFTA via 11 U.S.C. § 544(b)) may consider *BFP* as persuasive, they are not bound by the holding even in cases involving real property foreclosure sales.").

123. See Murray, *Guaranties and Fraudulent Transfers*, *supra* note 112.

124. *Id.*

become due. This analysis necessarily involves credit underwriting and generally is beyond the expertise of most title underwriters.

The following inquiries will assist the title underwriter in assessing the risk of whether a property sale is being made for reasonably equivalent value:

- How was the selling price established? By MAI appraisal? By internal appraisal? By market analysis using licensed real estate brokers from the geographic area where the land is located? By negotiation?
- If the price was established by negotiation, did separate independent legal counsel and/or other professionals (e.g., real estate brokers, investment bankers) represent each party? Is the seller motivated to obtain the best price possible for the property? Is the transaction truly "arms length," or is there some relationship between the seller and purchaser? How does the sales price compare to other indicators of value that might be available (e.g., valuation for property tax assessment established by the applicable local government authority, recent professional appraisal, or comparable sales statistics in the relevant geographical area)?
- Is there pending litigation against the seller or any other information known that could suggest a motive on the seller's part to "hinder, delay or defraud" creditors?

Determining reasonably equivalent value is more straightforward in the context of a loan transaction. The basic question is: Who is receiving the benefit of the loan proceeds? To answer that question, the title insurer must "follow the money." If the proceeds are all being disbursed to the borrower or for the borrower's benefit, such as in a refinance transaction where the new loan proceeds are disbursed to pay off an existing secured obligation owed by the same borrower, then the lender would appear to be receiving full value for the transfer of the mortgage lien securing the new loan. However, such an apparently "clean"¹²⁵ transaction can still result in a fraudulent transfer challenge if the loan proceeds are disbursed to the borrower and, in a second "related" transaction, the borrower "upstreams" the funds to its parent or "cross-streams" the funds into a "sister" entity.¹²⁶ Unfortunately, a court may, and often does, "collapse" a series of related transactions into one for purposes of applying fraudulent transfer law.¹²⁷

125. *Id.*

126. *Id.*

127. See *infra* note 163 and accompanying text (discussing fraudulent transfers in the context of leveraged buyout transactions and the ability of the

Where less than reasonably equivalent value is given for a transfer, a bankruptcy trustee or creditor can void the transfer if any one of three alternative financial tests, as set forth in § 548(a)(1)(B)(ii) of the Code, can be met. These tests are discussed in some detail below and require, respectively, a determination of whether the transferor is (1) insolvent at the time of the transfer or rendered insolvent by the transfer, (2) engaged in business or a transaction for which it has unreasonably small capital, or (3) about to incur debts beyond its ability to pay as they become due.¹²⁸ This analysis necessarily involves credit underwriting.¹²⁹

Among the most common types of transactions in which constructive fraudulent transfer (and, in particular, “reasonably equivalent value”) issues are present are “upstream” or “sidestream” transfers (and, less often, “downstream” transfers). Examples of transactions in which these issues may be present are the following:

- Leveraged buyouts;
- Mortgage loans to finance partner buyouts;
- Transfers of all or a portion of the mortgage proceeds to a parent or sister entity;
- Guarantees of the mortgage indebtedness of a parent or sister entity (often secured by a mortgage on the guarantor’s property);
- Cross-collateralization of existing mortgages with new or existing mortgage obligations owed by others;
- Mortgages to secure debt proceeds distributed as dividends;
- Transfers of assets to general partners, or other equity participants; and
- The issuance of partnership or other equity interests in exchange for the contribution of real property (or properties).

Any of the foregoing transactions, depending on the facts, could result in a transfer for less than adequate consideration, or (1) cause the person or entity making the transfer to become insolvent under the first prong of the constructive fraudulent-transfer analysis set forth above, (2) cause the buyer or borrower to be left with insufficient capital to fund its business under the second prong of the analysis, or (3) cause the buyer or borrower to be unable to pay its debts as they become due under the third prong of the analysis.

An “upstream” loan transaction generally refers to any lending transaction whereby all or some portion of the loan

bankruptcy court to “collapse” a series of related transactions).

128. 11 U.S.C. § 548(a)(1)(B)(ii)(I)–(III).

129. *Id.*

proceeds are distributed to the equity owner or "parent" of the actual borrowing entity. A "cross-stream" or "sidestream" loan transaction refers to the situation where all or some of the proceeds are distributed to an affiliated or "sister" entity. In either event, a fraudulent transfer may occur under state law or under § 548 of the Code because the borrower has not received the proceeds but remains obligated for the debt, or has encumbered its real estate as security for the loan, and therefore may not have received reasonably equivalent value in return. Obligations that debtors incur solely for the benefit of third parties are presumptively not supported by a reasonably equivalent value.¹³⁰

An "upstream" guaranty occurs where the parent—which is the equity owner of a subsidiary corporation, partnership, or limited liability company—is the borrower and receives the proceeds of a loan that is guaranteed by the subsidiary and the assets of the subsidiary are pledged as security for the guaranty. However, the existence of an upstream transfer, where the consideration has passed to a third party, does not conclusively establish that the transferor did not receive reasonably equivalent value. A subsidiary that guarantees a parent's debt could, for example, receive indirect benefits such as securing a future sale, obtaining a line of credit otherwise unavailable, or even improving its public image or "goodwill" through consummating a large transaction.¹³¹

A "downstream" guaranty transaction is simply the reverse of the upstream transaction. The parent is guaranteeing a loan made to its subsidiary and the parent pledges its assets as security. A "cross-stream" guaranty transaction involves affiliated "sister" entities (in the sense that they share a common parent) where one entity obtains a loan, which is guaranteed by a sister entity and secured by the sister entity's assets.¹³²

130. See, e.g., *Rubin v. Mfrs. Hanover Trust Co.*, 661 F.2d 979, 989 (2d Cir. 1981); *Marquis Prods., Inc. v. Conquest Carpet Mills, Inc.*, 150 B.R. 487, 491 (Bankr. D. Me. 1993) (stating that "as a general rule, an insolvent debtor receives 'less than a reasonable equivalent value' where it transfers its property in exchange for a consideration which passes to a third party") (internal quotation and citations omitted).

131. See, e.g., *Mellon Bank*, 945 F.2d at 647 ("[I]t is appropriate to take into account intangible assets not carried on the debtor's balance sheet, including, *inter alia*, good will."); *Telefest, Inc. v. VU-TV, Inc.*, 591 F. Supp. 1368, 1379 (D.N.J. 1984) (holding that a security agreement executed for the benefit of an intervenor creditor by defendant debtor and its parent company was not a fraudulent conveyance); *In re Marquis Prods., Inc.*, 150 B.R. at 491 ("[A] subsidiary receives an indirect benefit where its upstream guarantee enables its parent to procure a loan and, thus, to provide funds to the subsidiary.").

132. With respect to inter-corporate guaranties, courts have classified such transactions "into three categories: first, where a parent corporation or principal guarantees a subsidiary's obligation is termed a downstream guaranty; second, where a subsidiary guarantees the obligation of its sister

An upstream or cross-stream transaction is most likely to be challenged on the basis that the transferor did not receive reasonably equivalent value. On the other hand, downstream transfers, involving transfers by the debtor-parent corporation to a subsidiary (at least where the subsidiary is solvent) generally meet the reasonably-equivalent-value test because the parent, which is usually the sole stockholder of the subsidiary, also receives any benefit that accrues to the subsidiary resulting from the transfer. There is thus deemed to be an "identity of interest" between the parties. With respect to a payment or guarantee by a debtor corporation of a loan to its wholly owned subsidiary, the reduction of the subsidiary's debt by virtue of payments under the guaranty theoretically increases, on a dollar-for-dollar basis, the value of the stock in the subsidiary owned by the parent.¹³³ However, this presumption may be rebutted by evidence to the contrary.¹³⁴

corporation is termed a cross-stream guaranty; and third, where a subsidiary guarantees the parent's obligations is termed an upstream guaranty." *Commerce Bank of Kansas City v. Achtenberg*, No. 90-0950-CV-W-6, 1993 U.S. Dist. LEXIS 16136, at *11 n.4 (W.D. Mo. Nov. 10, 1993). See also *In re Metro Communications, Inc.*, 95 B.R. 921, 933 (Bankr. W.D. Pa. 1989), (holding that a transfer by a debtor that only operates to benefit an affiliated entity is a fraudulent transfer), *rev'd on other grounds*, 945 F.2d 635 (3d Cir. 1991).

133. See *Rubin*, 661 F.2d at 991 (holding that § 548 of the Code does not authorize avoiding a transfer that "confers an economic benefit upon the debtor," either directly or indirectly); *Branch v. FDIC*, 825 F. Supp. 384, 400 (D. Mass. 1993) (noting that "[t]he court is aware of no case in which transfers to a solvent subsidiary have been determined to be for less than equivalent value"); *Metro Communications*, 95 B.R. at 933; *In re W.T. Grant Co.*, 699 F.2d 599, 608-09 (2d Cir. 1983) (finding no fraudulent transfer in connection with downstream transfer where the debtor, through its subsidiary, received full benefit of short-term loans and additional loans in return for its guaranty and security interests); *In re Lawrence Paperboard Corp.*, 76 B.R. 866, 874 (Bankr. D. Mass. 1987) (holding that downstream guaranties were supported by fair consideration because parent corporation received the benefit of any loans by the creditor as a result of its stock ownership); *In re First City Bancorporation*, No. 392-39474-HCA-11, 1995 Bankr. LEXIS 1683, at *34 n.9 (Bankr. N.D. Tex. May 15, 1995) (transfer to wholly owned solvent subsidiary may be for reasonably equivalent value because value of parent's stock interest in subsidiary may be correspondingly increased).

134. See, e.g., *Achtenberg*, 1993 U.S. Dist. LEXIS 16136, at *14 n.5 (finding that with respect to downstream guaranties of a corporate loan by two individuals who were the corporation's sole shareholders, the debtor corporation was insolvent at the time of the guaranties and that such insolvency eliminated any indirect benefit to shareholders-guarantors, but stating that if the debtor was only "marginally insolvent" at the time of transfer, reasonably equivalent value might be found to exist). See also *Gen. Elec. Credit Corp. v. Murphy*, 895 F.2d 725, 727-28 (11th Cir. 1990) (holding that the debtor corporation did not receive reasonably equivalent value where its individual shareholder guaranteed debt of the debtor corporation's wholly owned subsidiary, but the debtor corporation acted as if it were a guarantor

When analyzing whether reasonably equivalent value exists in connection with a cross-stream guarantee by a corporation of a sister entity's debt, courts often focus on whether such guaranties are customary and reasonably expected by creditors, and whether such obligations enhance the financial strength of the entire corporate "group," either directly or indirectly, and therefore provide value to all of the members.¹³⁵ If, instead, the result of such guaranties is that the creditors of a high-performing solvent entity are put at increased risk for the sake of an affiliated entity that is insolvent or on the brink of insolvency, then courts are more likely to find that the transfer was made for less than reasonably equivalent value and therefore constructively fraudulent.¹³⁶ Often, the subsidiaries are of varying financial strength and creditors of a stronger subsidiary may be put at increased and unreasonable risk as a result of the cross-guaranty.¹³⁷ The courts will analyze closely whether the cross-guaranty obligation results in a true benefit to the debtor, such as increased synergy with the group or increased credit availability, and whether the corporate group as a whole was a viable business enterprise at the time of the guaranty.¹³⁸

and actually made loan payments to the lender after the loan was in place); *In re Duque Rodriguez*, 77 B.R. 937, 939 (Bankr. S.D. Fla. 1987) (ruling that a transfer was made while the parent corporation was insolvent and therefore the parent did not receive reasonably equivalent value), *aff'd*, 895 F.2d 725 (11th Cir. 1990); *First City Bancorporation*, 1995 Bankr. LEXIS 1683, at *34 n.9 (transfer to insolvent subsidiary was not for reasonably equivalent value because parent's shares in subsidiary had no value).

135. See Murray, *Creditors' Rights*, *supra* note 1.

136. *Id.*

137. *Id.* See *Branch*, 825 F. Supp. at 400 (rejecting the defendant's motion to dismiss the complaint alleging transfers to solvent subsidiaries were not for reasonably equivalent value where the subsidiaries could be liable for the guarantee of the debt in connection with an insolvent sister subsidiary).

138. See *Mellon Bank*, 945 F.2d at 646-47 (reasoning that the trustee had the burden of showing that a transfer of funds made during a leveraged buyout of the debtor was for less than reasonably equivalent value under § 548(a)(1)(B)(i)); *Telefest*, 591 F. Supp. at 1381 (D.N.J. 1984) (holding that the defendant corporation, as a whole, was not insolvent at the time of the agreement and that there was fair consideration in the conveyance); Robert J. Rosenberg, *Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware*, 125 U. PA. L. REV. 235, 236 (1976) (exploring theories as to whether certain guaranties "give the lender a right to the assets of the guarantor equal to or, if the guaranty is secured, senior to that of the guarantor's other creditors"); Jack F. Williams, *The Fallacies of Contemporary Fraudulent Transfer Models as Applied to Intercorporate Guaranties: Fraudulent Transfer Law as a Fuzzy System*, 15 CARDOZO L. REV. 1403, 1420-22 (1994) (addressing how to analyze whether an intercorporate guarantor received reasonably equivalent value in exchange for an obligation incurred at time the guarantor was insolvent or rendered insolvent); Barry L. Zaretsky, *Fraudulent Transfer Law as the Arbiter of Unreasonable Risk*, 46 S.C. L. REV. 1165, 1194-95 (1995) (noting that "if certain corporate group members receive

Upstream, downstream, and cross-stream transactions can also be effected through cross-collateralization, even in the absence of a formal guaranty.¹³⁹ To pledge one's assets as security for the obligation of another is to become a guarantor regardless of whether any document evidencing the guaranty obligation is executed.¹⁴⁰ Cross-collateralization has become a very common structuring technique in securitized loan transactions. Typically, as required by the lender (especially in securitizations), a "bankruptcy remote" or "special purpose" entity ("SPE") is created, to which certain assets of a parent entity will be conveyed that are intended to act as security for the loan.¹⁴¹

An SPE generally will have the following characteristics as a part of its organizational documents (articles of incorporation and bylaws if it is a corporation; partnership agreement if it is a partnership; or operating agreement if it is a limited liability company)[1.] The business purpose of the borrower will be limited to owning and operating the specific property that is the subject of the securitized loan.[2.] The borrower may not incur any debt, whether secured or unsecured, other than the securitized loan in question (there may be an exception to this requirement for small working capital lines and other trade payables incurred in the ordinary course of business).[3.] The borrower will be required to keep its funds and activities separate from those of any other entity.[4] The organizational documents must state that in making decisions (and particularly in deciding whether to file any voluntary bankruptcy case) the members, [general partner(s),] or board of directors must take into account the interest of creditors as well as the interest of

no reasonably equivalent benefit and the new liability renders them financially impaired, the guaranty may create the type of unreasonable risk to creditors of those members that is proscribed by fraudulent transfer law").

139. See John C. Murray, *Loan Guaranties: Advanced Issues* (2001), available at <http://www.firstam.com/faf/pdf/jmurray/loanguaranties.pdf>.

140. *Id.*

141. *Id.* As a result of their negative experiences in recent years involving bankruptcy filings by and against borrowers, real estate lenders have learned that if a borrowing entity with very few creditors is created, such as a bankruptcy-remote limited liability company, it will be much more difficult for the borrower to file, or have filed against it, a bankruptcy proceeding or avoid early dismissal. See, e.g., *Barakat v. Life Ins. Co. of Va.*, 99 F.3d 1520, 1528 (9th Cir. 1996) (holding that where the only bona fide, impaired claim in the bankruptcy case was the claim of the mortgage lender, the debtor "should [not] be able to cramdown a plan that disadvantages the largest creditor"); John C. Murray, *The Lender's Guide to Single Asset Real Estate Bankruptcies*, 31 REAL PROP. PROB. & TR. J. 393, 461-71 (Fall 1996) [hereinafter Murray, *The Lender's Guide*]; James R. Stillman, Real Estate Mezzanine Financing in Bankruptcy, Finance Topics, American College of Real Estate Lawyers, Midyear Meeting, Scottsdale, Arizona, Apr. 4-5, 1997, Tab 24, at 3; Gregory V. Varallo & Jesse A. Finkelstein, *Fiduciary Obligations of Directors of the Financially Troubled Company*, 48 BUS. LAW. 239, 254 (1992); John C. Murray, *Bankruptcy - Reorganization Under Chapter 11*, in THE LAW OF DISTRESSED REAL ESTATE, §§ 29:73-29:86 (2004).

shareholders [or other equity participants].[5.] One of the controlling members of the borrower must be an independent party. This independent party may be affiliated with the originator of the securitized loan or may be . . . affiliated with one of the national corporate record keeping companies [created to perform this function]. The organizational document of the borrower will then require the concurrence of this independent party before any bankruptcy proceeding can be filed.¹⁴²

The purpose of this “bankruptcy remote” structure is to make it difficult for the SPE borrower to file for bankruptcy.¹⁴³ However,

142. William G. Murray, *Workouts in the Twenty-First Century*, 17 CAL. REAL PROP. J. 1, 5 (1999).

143. See Comm. on Bankr. & Corporate Reorganization of the Ass'n of the Bar of the City of New York, *New Developments in Structured Finance*, 56 BUS. LAW. 95, 101 (2000) (noting that the bankruptcy-remote aspects of a special-purpose entity may be enhanced by requiring that one or more of the directors, general partners, or members of the special-purpose entity be independent, or by requiring a super-majority vote—which would necessarily include at least one of the independent parties—to approve a voluntary bankruptcy filing); Comm. on Bankr. & Corporate Reorganization of the Ass'n of the Bar of the City of New York, *Structured Financing Techniques*, 50 BUS. LAW. 527, 559, 598 (1995) (exploring history, structural elements, and underlying legal basis of structured findings); Tribar Opinion Comm., *Opinions in the Bankruptcy Context: Rating Agency, Structured Financing, and Chapter 11 Transactions*, 46 BUS. LAW. 717, 724-30 (1991) (examining attorney opinions given with respect to bankruptcy issues in financial and commercial transactions). An employee, officer, or representative of the lender could obtain a direct ownership or equity interest in the SPE, but this would invite subsequent challenges based on lender liability, equitable subordination, and violations of public policy. Numerous courts have held that as a corporation approaches insolvency, the directors owe a fiduciary duty to the creditors of the corporation. See, e.g., *In re Kingston Square Assocs.*, 214 B.R. 713, 735 (Bankr. S.D.N.Y. 1997) (“[I]t is universally agreed that when a corporation approaches insolvency or actually becomes insolvent, directors’ fiduciary duties expand to include general creditors. Nearly all states’ law is in accord. . . .”); *In re Cumberland Farms, Inc.*, 249 B.R. 341, 349 (Bankr. D. Mass. 2000) (noting that directors must act “with absolute fidelity and must place their duties to the corporation above every other financial or business obligation. . . . They cannot be permitted to serve two masters whose interests are antagonistic”). But see *Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc.)*, 225 B.R. 646, 655 (N.D. Ill. 1998) (ruling that directors’ fiduciary obligation, when the corporation is near insolvency, requires only that they “exercise judgment in an informed, good faith effort to maximize the corporation’s long-term wealth-creating capacity”). Cf. *In re Cent. European Indus. Dev. Co.*, 288 B.R. 572, 575 (Bankr. N.D. Cal. 2003) (“independent” director, chosen and strategically placed by lender, actually voted for special purpose, “bankruptcy remote” debtor entity to file for Chapter 11 bankruptcy). See also Steven L. Schwarcz, *Rethinking a Corporation’s Obligations to Creditors*, 17 CARDOZO L. REV. 647, 671 (1996) (“It is not the corporation’s closeness to insolvency that is relevant, but rather whether, under the circumstances, a corporation’s contemplated action would cause insolvency, meaning that insolvency is one of the reasonably expected outcomes.”); Andrew D. Shaffer, *Corporate Fiduciary—Insolvent: The Fiduciary Relationship Your Corporate Law Professor (Should Have) Warned You About*,

bankruptcy “remote” does not mean bankruptcy “proof” and, as one author has stated, “the nature of securitized loans is such that a bankruptcy court may be the only venue where meaningful relief can be obtained.”¹⁴⁴ In many commercial transactions, it is not uncommon to create as many bankruptcy-remote entities as there are real property assets or, in multi-state transactions, to form as many bankruptcy-remote borrowing entities as there are states. Each newly created entity will typically be an SPE that is wholly owned by the parent entity (although not always on a direct basis).¹⁴⁵ The entity formed to hold title to the real property asset may be owned by another entity or entities, often a bankruptcy-remote SPE or SPEs, which may in turn be wholly owned by the ultimate parent.¹⁴⁶

The ultimate purpose of the loan may simply be to refinance existing secured debt.¹⁴⁷ If the loan were made to the parent, which pledged its own assets as security for the loan, and the proceeds were used to pay off the parent’s existing secured debt, there would likely be no creditors’ rights issue and the title insurer could be expected to insure the transaction without a creditors’ rights exclusion.¹⁴⁸ However, because the lender or the rating agency that will be rating the transaction (if it is to be securitized) desires to isolate the assets that will be the security from the parent’s general business operations and other creditors, a

8 AM. BANKR. INST. L. REV. 479, 517 (2000); Christopher W. Frost, *The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations*, 72 AM. BANKR. L.J. 103, 107-08 (1998) (“[T]he general rule is that directors do not owe creditors duties beyond the relevant contractual terms absent ‘special circumstances . . . , e.g., insolvency. . . . When the insolvency exception does arise, it creates fiduciary duties for directors for the benefit of creditors.”); Glenn E. Siegel et al., *What Duty Is Owed in Vicinity of Bankruptcy?* N.Y.L.J., Feb. 19, 2002, at 1; Comm. on Bankr. & Corporate Reorganization of the Ass’n of the Bar of the City of New York, *New Developments in Structured Finance*, 56 BUS. LAW. 95, 162-66 (2000) (discussing fiduciary duties of directors and the impact of *Kingston Square*); Gregory Varallo & Jesse A. Finkelstein, *Fiduciary Obligations of Directors of the Financially Troubled Company*, 48 BUS. LAW. 239 (1992).

144. See Murray, *Guaranties and Fraudulent Transfers*, *supra* note 112 (discussing *Kingston Square*, 214 B.R. at 713, where the court refused to dismiss an involuntary bankruptcy petition orchestrated by the principal of an involuntary debtor in order to avoid bankruptcy-remote provisions in the debtor entity’s organizational documents). The use of an SPE may create a false sense of security with respect to insulation from bankruptcy risk. *Id.* See also Tim Reason, *False Security*, CFO, June 2003, at 59 (“At the Bond Market Association’s annual meeting in New York in April, the moderator of a panel on asset-backed securitization (ABS) joked that this enormously popular form of structured financing has ‘proven to be bankruptcy remote – except perhaps in the event of bankruptcy.’”).

145. See Murray, *Guaranties and Fraudulent Transfers*, *supra* note 1.

146. *Id.*

147. *Id.*

148. *Id.*

bankruptcy-remote SPE will be the preferred form of borrowing entity.

There are at least two transfers in these transactions that must be analyzed for creditors' rights issues: (1) the transfer of title from the parent to the newly created entity (or entities) of the assets that will be the security for the loan, and (2) the mortgaging of those assets by the newly formed entity or entities. The actual borrower may be the parent in which event the transaction in effect becomes an upstream guaranty, but it is usually the bankruptcy-remote SPE itself. A separate loan might be made to each SPE, secured by the asset or assets of that particular SPE received from the parent. If the structure stopped there, and assuming that the loan became the SPE's obligation at the time title to the asset or assets was conveyed by the parent to the SPE and that the parent received "reasonably equivalent value" for its transfer to the SPE, the loan transaction involving the existing secured debt might not involve a creditors' rights issue (except possibly an intentional fraudulent transfer). However, rarely is this type of loan transaction structured as a series of truly "stand alone" loans to each separate SPE. Instead, each SPE pledges its asset or assets as security for its own promissory note *and* for the promissory notes executed by each of the other "sister" SPEs. There may be a formal guaranty executed by each SPE of the indebtedness of each of these other SPEs, which in turn may be secured by a subordinate mortgage on each of the other properties mortgaged by the respective SPEs. This results in cross-collateralization, as each asset stands as collateral for the "global" loan (being the sum of all of the separate loans made to each SPE), although each individual SPE has only benefited from a portion of the loan proceeds.

The common theme in upstream, downstream, and cross-stream transactions is that someone other than the entity whose assets stand as security for the loan is benefiting from the loan proceeds and, at least to the extent of the benefit flowing to the parent, subsidiary or sister entities, the "transferring" entity may not be receiving reasonably equivalent value. Therefore, a fraudulent transfer challenge can be made by the bankruptcy trustee of the parent, who could attack the transfer to the SPE as one (1) made to "hinder, delay or defraud" the parent's existing or future creditors; (2) that rendered the parent insolvent; (3) that left the parent with insufficient capital to carry on its business; or (4) that occurred when the parent was unable to pay its debts as they became due. The transfer of assets by a parent to a subsidiary also could constitute a preference if the parent had guaranteed the subsidiary's indebtedness, and is subsequently released from the guaranty obligation when the subsidiary uses the proceeds of the new secured loan to satisfy an existing

obligation of the subsidiary that the parent had guaranteed.

Since the early 1980s, borrowers and title companies have struggled to come up with a method of minimizing the risks of fraudulent conveyances in mortgage loan transactions, especially in connection with multi-property, multi-borrower, securitized, and multi-state transactions, while still providing lenders the protection that they are seeking when utilizing devices such as upstream and sidestream guaranties. Proposed solutions, which have been used with varying degrees of acceptance and success, include the following:

- A “net worth” limitation, under which the guarantor guarantees all or a portion of another borrower’s indebtedness or the aggregate indebtedness of numerous separate borrowing entities, but limiting such liability to an amount not greater than, e.g., ninety-five percent of its own net worth on an ongoing basis, or \$100,000 less than the greatest amount that would not constitute a fraudulent transfer or conveyance under applicable state or federal law either at the time of the borrower’s incurrence of the obligation or the performance of its obligations under the loan documents (in order to maximize the benefit of this structuring technique, the net worth limitation should address each of the alternative financial tests of a fraudulent transfer under § 548(a)(1)(B)(ii) of the Code, i.e., insolvency, capitalization, and cash flow);¹⁴⁹
- Statements or provisions in the guaranty agreements and any mortgages securing such guaranty obligations, to the effect that it is the parties’ intention that the obligations of each guarantor shall not constitute a fraudulent transfer or conveyance under the Code or any applicable state statute;
- A separate affidavit and certificate verifying the organizational and financial status of the guarantor(s) and the debts and liabilities of the guarantor(s);
- A “contribution agreement” among all the borrowers-guarantors providing that in the event that any individual borrower-guarantor guaranteeing the

149. 11 U.S.C. § 548(a)(1)(B)(ii). Notwithstanding their increasing use and the benefits provided by such provisions and documents, guaranties with net worth limitations may have the following disadvantages: (1) the difficulty of determining and verifying the actual net worth of the guarantor (or multiple guarantors) at any given point in time; (2) the potential inability to collect the full amount of the guaranty because of the guaranty agreement’s limitation to a specified amount of the guarantor’s net worth and the possible miscalculation or misrepresentation of such net worth; and (3) the lack of reported court decisions determining the validity and enforceability of guaranties containing net worth limitations.

indebtedness of other borrowers-guarantors is required to, and actually does, make a payment on such guaranty for the benefit of another borrower-guarantor, it will thereupon have a right of indemnification and contribution against the defaulting borrower-guarantor for the amount (which may be an allocated portion of the aggregate debt) paid by the non-defaulting borrower-guarantor; and

- An indemnification agreement from the common principal or parent of each borrowing entity to the title insurance company (which indemnity may or may not be secured by additional collateral such as a cash deposit, certificate of deposit or letter of credit), indemnifying the title company for any claims asserted against it as the result of the lender's inability to realize on its security because a fraudulent transfer has been deemed to have occurred as a result of the transaction.¹⁵⁰

Concerns about upstream guarantees were highlighted in the 1980s, when courts began to apply both state and federal fraudulent conveyance law to leveraged buyout transactions ("LBOs"). A leveraged buyout refers to the acquisition of a "target" entity, where all or a substantial portion of the purchase price paid for the stock or other equity interests of the target entity is borrowed from a third party and the loan financing the transaction is secured by real and personal assets of the target entity.¹⁵¹ Usually the buying entity infuses little or none of its own funds as equity, and therefore the transaction results in equity being exchanged for debt, with the target entity receiving little, if any, value.¹⁵²

A highly leveraged transaction, such as an LBO, significantly affects a company's capital structure.¹⁵³ After the leveraged buyout occurs, the company has a significantly increased debt burden.¹⁵⁴ The claims and priorities of the creditors and equity with respect to the company's assets are altered, reflecting the risk-return relationship between debt and equity. Sometimes the structure will be more complicated in an effort to make it appear that the borrowing entity is actually receiving the benefit of the loan proceeds and, hence, "reasonably equivalent value."¹⁵⁵ In

150. See Murray, *Guaranties and Fraudulent Transfers*, *supra* note 112, which contains, as exhibits, sample forms of documents and provisions to implement these proposed solutions.

151. *Id.*

152. *Id.*

153. *Id.*

154. *Id.*

155. *Id.*

fact, the loan proceeds initially may be disbursed to the borrowing entity such as the corporation, partnership, or LLC whose equity interests are being purchased, but usually that is only the first step in a multiple-step transaction that is structured from the outset to provide financing for the purchase of the equity interests.

In another form of complex LBO structure, a new corporation may be formed to buy the stock in the company to be acquired.¹⁵⁶ The new corporation would obtain a loan in the amount needed to purchase the stock and then pay the loan proceeds to the shareholders in the company to be acquired in exchange for their stock. Once in control of the company to be acquired, the new owner would then cause the company to obtain a loan and to encumber its assets as security; the proceeds of the new loan would be used to repay the loan that had been obtained by the acquiring corporation to fund the stock purchase.¹⁵⁷

Upstream transactions are characterized, in the case of an LBO, by subsidiary guarantees of the debt obligations of the guarantor's new parent corporation to the lender that financed the acquisition of the stock of the subsidiary-guarantor.¹⁵⁸ In an LBO or series of LBOs, the transferor generally receives less than reasonably equivalent value because it conveys the property in exchange for consideration that passes to a third party.¹⁵⁹ Clearly, a fraudulent transfer issue is presented. As stated by the Court of Appeals for the Third Circuit in *Mellon Bank v. Metro Communications, Inc.*,¹⁶⁰ "[t]he target corporation . . . receives no direct benefit to offset the greater risk of now operating as a highly leveraged corporation."¹⁶¹ The court further noted that:

The effect of an LBO is that a corporation's shareholders are replaced by secured creditors. Put simply, stockholders' equity is supplanted by corporate debt. The level of risk facing the newly structured corporation rises significantly due to the increased debt to equity ratio. This added risk is borne primarily by the unsecured creditors, those who will most likely not be paid in the event of bankruptcy. . . . An LBO may be attractive to the buyer, seller and lender because the structure of the transaction could allow all parties to the buyout to shift most of the risk of loss to other

156. *Id.*

157. *See* *Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488, 495 (N.D. Ill. 1988) (upholding the plaintiffs' claim except against non-controlling shareholders because an LBO can constitute a fraudulent transfer); *MFS/Sun Life High Yield Series v. Van Dusen Airport Servs. Co.*, 910 F. Supp. 913, 937 (S.D.N.Y. 1995) ("Because the assets of the target are pledged as security for a loan that benefits target's former owners rather than the target itself, it is unlikely that any LBO can satisfy fair consideration requirements.").

158. *Id.*

159. *Id.*

160. 945 F.2d 635, 646 (3d Cir. 1991).

161. *Id.*

creditors of the corporations if the provisions of section 548(a)(2) [sic] were not applied.

The selling shareholders receive direct benefit in the LBO transaction as they are cashed out. . . . The lender is attracted by the higher interest rates and fees usually associated with LBOs. The target corporation, however, receives no direct benefit to offset the greater risk of now operating as a highly leveraged corporation.¹⁶²

Where it is alleged that the lender knew that the borrowing entity would not receive the loan proceeds, but would nevertheless assume responsibility for repaying the debt, and it is further alleged that the eventual insolvency and bankruptcy of the borrower were foreseeable results of the leveraged buyout, the trustee in bankruptcy has adequately pleaded a cause of action for fraudulent conveyance and may seek to "collapse" the various loans, stock purchases and repayment obligations into one transaction.¹⁶³

Any combination or number of transfers that are part of an LBO may be attacked as fraudulent transfers.¹⁶⁴ All parties to an LBO can be affected by a fraudulent transfer claim.¹⁶⁵ A corporation, including its directors and controlling shareholders, may have breached its duty to the corporation's creditors.¹⁶⁶ In addition, selling shareholders may be obligated to return the sale proceeds, and the liens of secured creditors may be fully or partially avoided or subordinated to other claims.

The lender may be required to make a reasonable determination that the leveraged buyout is consistent with the rights of the borrower's—i.e., the target company's—unsecured creditors before disbursing the loan funds, because it is essential to view such transactions from the perspective of such creditors.¹⁶⁷ Also, when a target company assumes liabilities or transfers

162. *Id.* at 645-46.

163. *See, e.g.*, *CPY Co. v. Ameriscribe Corp. (In re Chas. P. Young Co.)*, 145 B.R. 131, 137 (Bankr. S.D.N.Y. 1992), in which the court stated that:

Regardless of the number of steps taken to complete a transfer of debtor's property, such as in a leveraged buyout transaction, if they reasonably collapse into a single integrated plan and either defraud creditors or leave the debtor with less than equivalent value post-exchange, the transaction will not be exempt from the Code's avoidance sections.

See also Orr, 991 F.2d at 35 (holding that an allegedly fraudulent transfer must be evaluated in context, and "where a transfer is only a step in a general plan, the plan 'must be viewed as a whole with all its composite implications'").

164. *See generally Murray, Creditors' Rights, supra* note 1.

165. *Id.*

166. *Id.*

167. *Id.*

security interests in its property and the consideration or loan proceeds are immediately passed to the target company's shareholders or third parties, lack of fair or reasonable consideration is usually presumed.¹⁶⁸

168. See *Orr*, 991 F.2d at 36 (finding fraudulent conveyance under state law, where the lender knew that net effect of its mortgage loan was transfer of the property without any benefit to the debtor-transferor); *MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Servs. Co.*, 910 F. Supp. 913, 945 (S.D.N.Y. 1995) (holding that while fraudulent conveyance law did apply to LBOs, it was not intended to provide creditors with insurance against any company failure); *In re Revco D.S., Inc.*, 118 B.R. 468, 473-74 (Bankr. N.D. Ohio 1999) (holding that fraudulent conveyances apply to LBOs); *Crowthers McCall Pattern, Inc. v. Lewis*, 129 B.R. 992, 998 (Bankr. S.D.N.Y. 1991) (noting that "under the fraudulent conveyance laws, a lender is required to make a reasonable determination that the buy out is consistent with the rights of creditors before advancing funds"); *Murphy v. Meritor Sav. Bank (In re O'Day Corp.)*, 126 B.R. 370, 412 (Bankr. D. Mass. 1991) ("[T]he Bank set out on a course to improve its own position to the serious detriment of the unsecured creditors."); *Aluminum Mills Corp. v. Citicorp N. Am., Inc. (In re Aluminum Mills Corp.)*, 132 B.R. 869, 886-87 (Bankr. N.D. Ill. 1991) (holding that fraudulent conveyance laws apply to LBOs); *In re Resorts Int'l, Inc.*, 145 B.R. 412, 458 (Bankr. D.N.J. 1990) ("Courts have not hesitated to apply state fraudulent conveyance law to leveraged buyouts, particularly in cases where there is evidence of intent to defraud and knowledge of the LBO."); *Wieboldt Stores*, 94 B.R. at 499 (holding that fraudulent conveyance laws apply to LBOs); *In re Ohio Corrugating Co.*, 91 B.R. 430, 441 (Bankr. N.D. Ohio 1988) ("[T]ransfers between a purchaser and the target company in an LBO ought to be subject to avoidance as a fraudulent transfer."); *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556, 585 (M.D. Pa. 1983) (applying fraudulent conveyance law to an LBO). See also Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 832-33 (1985) (noting that the issue of fraudulent conveyances became important in the 1980s); David A. Murdoch et al., *Leveraged Buyouts and Fraudulent Transfers: Life After Gleneagles*, 43 BUS. LAW. 1 (1987) (examining impact on leveraged buyouts in discussion of *United States v. Tabor Court Realty Corp.*, 803 F.3d 1288 (3d Cir. 1986)); Matthew T. Kirby et al., *Fraudulent Conveyance Concerns in Leveraged Buyout Lending*, 43 BUS. LAW. 27 (1987) (noting that the *Tabor Court Realty* decision downplays the need for lenders to consider applicability of fraudulent conveyance law to leveraged buyout financing). But see *Kupetz v. Wolf*, 845 F.2d 842, 848 (9th Cir. 1988) (refusing to find a fraudulent conveyance as a result of a sale of the debtor corporation in a leveraged buyout where there was no actual intent to defraud and shareholders had no knowledge of the LBO structure used to purchase their shares; the court declined to analyze a leveraged buyout under the constructive fraud provisions of the California UFCA on the theory that it would be "[i]nappropriate to utilize constructive intent to brand most, if not all, LBOs as illegitimate"); *Mellon Bank*, 95 B.R. at 932-33 (ruling that, although the bankruptcy statute prohibiting fraudulent transfers applies to leveraged buyouts, there is no per se rule that a leveraged buyout loan collateralized with the target's own assets renders the target debtor insolvent and, therefore, automatically vulnerable to fraudulent transfer attack); *Wieboldt Stores*, 94 B.R. at 500 (noting that "[a]lthough . . . fraudulent conveyance laws generally are applicable to [LBO] transactions, a debtor cannot use these laws to avoid any and all [LBO transactions]"); *Ohio*

Numerous state courts, when determining whether a fraudulent conveyance has occurred, especially in connection with leveraged buyout transactions, make a distinction between "fraud in law" and "fraud in fact." In *Aluminum Mills Corp. v. Citicorp North America, Inc.*,¹⁶⁹ the court noted that section 4 of the UFCA has been construed "as prohibiting not only 'fraud in law' . . . but also 'fraud in fact. . .'"¹⁷⁰ The court also stated that "[t]he proof requirements for finding intentional fraud under section 548(a)(1) and fraud in fact under Section 4 of the Illinois UFCA are substantially the same."¹⁷¹

Corrugating, 91 B.R. at 440 (holding that the transaction was not a fraudulent conveyance because plaintiffs had failed to prove that defendant was insolvent at the time of the leveraged buyout); *Ferrari v. Barclays Bus. Credit (In re Morse Tool, Inc.)*, 108 B.R. 389, 391 (Bankr. D. Mass. 1989) (holding that there was no fraudulent transfer despite debtor being left with unreasonably small capital).

169. 132 B.R. at 885

170. *Id.*

171. *Id.* See also *Klingman v. Levinson*, 114 F.3d 620, 626 (7th Cir. 1997) (noting that Illinois courts have divided fraudulent conveyance cases into categories of fraud in fact, which requires a showing of actual intent to hinder creditors, and fraud in law, which requires fraudulent intent when a voluntary transfer is made); *S.A.M. Elecs., Inc. v. Osaraprasop*, No. 96 C 7402, 1998 U.S. Dist. LEXIS 3214, at *12 (N.D. Ill. Mar. 16, 1998) ("In fraud-in-fact cases, the plaintiff must show that the defendant actually intended to hinder, delay or defraud a creditor."); *In re Telesphere Communications, Inc.*, 179 B.R. 544, 556 (Bankr. N.D. Ill. 1994) (acknowledging that constructive fraud claim can arise in the context of an LBO but holding that to prevail the claimant must show that the transferor received less than reasonably equivalent value); *Schacht v. Katten, Muchin & Zavis (In re Liquidation of Medicare HMO, Inc.)*, 689 N.E.2d 374, 380-81 (Ill. App. Ct. 1997) (ruling that plaintiff must allege the following to constitute a legally sufficient cause of action under fraud-in-law theory: "(1) a transfer made for inadequate consideration; (2) an existing or contemplated indebtedness owed by the transferor; and (3) the transferor's failure to retain sufficient property to repay his indebtedness," and finding that "[i]n fraud in fact cases, since actual consideration has been given for the transfer, a specific intent to defraud must be alleged and proved"); *Casey Nat'l Bank v. Roan*, 668 N.E.2d 608, 611 (Ill. App. Ct. 1996) (holding that "[p]roof of fraud in fact requires a showing of an actual intent to hinder creditors, while fraud in law presumes a fraudulent intent when a voluntary transfer is made for no or inadequate consideration and directly impairs the rights of creditors"), *appeal denied*, 675 N.E.2d 631 (Ill. 1996); *United States v. Paradise*, 127 F. Supp. 2d 951, 955 (N.D. Ill. 2000) ("Two categories of fraud exist regarding fraudulent conveyances under Illinois law: (1) fraud in fact, requiring proof of actual intent; and (2) fraud in law, where fraudulent intent is presumed when creditors' rights are directly impaired and the transfer is made for no or inadequate consideration."); *Bank of Aspen v. Fox Cartage, Inc.*, 511 N.E.2d 1234, 1236-37 (Ill. App. Ct. 1987) (holding that a transfer supported by consideration could not have been fraudulent in law, but only fraudulent in fact, a "theory requiring the proponent to demonstrate a fraudulent intent"); *Gary-Wheaton Bank v. Meyer*, 473 N.E.2d 548, 554 (Ill. App. Ct. 1984) (holding that "in fraud-in-law, fraud is presumed from the circumstances" where no consideration is exchanged).

If creditors are not paid following an LBO, as frequently happened in many of the LBOs that occurred during the 1980s, the bankruptcy trustee or DIP will almost certainly attack the mortgage lien as a fraudulent transfer on the basis that the transaction rendered the borrowing entity insolvent or left the borrower with inadequate capital to carry on its business.¹⁷² The transaction may also be attacked on the basis that the borrower was unable to pay its debts as they became due.¹⁷³

Absent a creditors' rights exclusion in the title policy insuring the lender, the title insurer in an LBO transaction may be required to pay for the lender's defense and, if unsuccessful in defeating the claim, may find itself paying substantial sums for loss and settlement.¹⁷⁴ Because of this risk, a title insurer is not likely to agree to delete the creditors' rights exclusion from the lender's title insurance policy, particularly when the target entity's business is not the real estate itself.

b. The Insolvency Test

This test involves an analysis of whether the transferor was insolvent at the time of, or became insolvent as a result of, the transfer or obligation.¹⁷⁵ The Code defines insolvency as a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation. . . ."¹⁷⁶ This is frequently referred to as the "balance sheet" test, i.e., whether the fair value of the debtor's total debts and liabilities exceeded the total value of its assets at the time it transferred value or incurred an obligation.¹⁷⁷ Some courts,

172. *Aluminum Mills*, 132 B.R. at 887-89.

173. *Id.* at 889.

174. Similar to an LBO, a "leveraged cashout" involves a situation where the equity owners of a business entity pull out the equity in the form of a dividend or distribution funded by the proceeds of a loan that they cause the entity to obtain, which is secured by the entity's assets. The borrowing entity itself does not receive reasonably equivalent value for the mortgage lien and other security interests it grants and the obligation it incurs. If the entity does not thereafter pay its creditors, the transaction likely will be attacked as a fraudulent transfer on the same basis as an LBO transaction.

175. This test is codified at 11 U.S.C. § 548(a)(1)(B)(ii)(I).

176. 11 U.S.C. § 101(32)(A).

177. See *Moulded Prod. Inc. v. Berry*, 474 F.2d 220, 225 (8th Cir. 1973) (holding that the proper valuation method in reorganization proceedings is the going concern value of the debtor's estate and that debtor is insolvent if the "aggregate amount of its property, as measured by its going concern value, is insufficient to pay its debts"); *Vadnais Lumber Supply, Inc. v. Byrne*, 100 B.R. 127, 131 (Bankr. D. Mass. 1989) (holding that for purposes of § 548, going concern value is the proper standard of valuation unless "at the time in question the business is so close to shutting its doors that a going concern standard is unrealistic"); *Moody*, 971 F.2d at 1067 (noting that under the Code, assets should be valued on a going concern basis unless the company is "on its deathbed"). Cf. *In re Westpointe, L.P.*, 241 F.3d 1005, 1008 (8th Cir.

however, have required that insolvency be determined in an "equity" sense, i.e., an inability to pay debts as they mature in the ordinary course of business.¹⁷⁸ But a court is not bound to apply generally accepted accounting principles in making its determination.¹⁷⁹ The trustee typically will rely on testimony of professionals such as accountants, appraisers or business-valuation experts to establish the fair value of the debtor's assets and liabilities at the time of the challenged transfer.¹⁸⁰

2001) (ruling that income capitalization was an acceptable method of valuation); *In re King Res. Co.*, 651 F.2d 1326, 1335-36 (10th Cir. 1980) (finding that capitalization of future earnings was a proper method of valuation); *Gleneagles Inv. Co.*, 565 F. Supp. at 578 ("[T]he test of solvency under the Act is the *present ability* to pay one's debts as they mature. . . .") (citation omitted).

178. See, e.g., *O'Donnell v. Royal Bus. Group, Inc.*, 180 B.R. 1, 11-12 (Bankr. D. Me. 1995) (finding that the debtor was equitably insolvent before, during, and after the transfer because its cash flow was "strained to the breaking point"). Other courts have blended the tests, and have examined both the reconstituted balance-sheet evidence and the debtor's ability to pay its debts as they mature. Still other courts apply a "total enterprise" test (the total fair value of the company's debt, plus the total fair value of the company's equity, minus the company's total excess cash), or an "orderly liquidation" test (calculating whether value remains if a company's assets were sold in an orderly liquidation and the proceeds were applied to the company's liabilities). In *In re Bruno's*, 228 F.3d 224, 233 (3d Cir. 2000), the court stated that

there are two basic approaches to this [insolvency] evaluation: asset by asset valuation, which ascribes value to each asset and determines solvency by comparing the sum of those assets to total liabilities[.] and enterprise valuation, which values the business as a going concern and includes intangibles such as relationships with customers and suppliers, and the name, profile, and reputation of the business.

Id. Utilizing the business enterprise evaluation test, the Examiner in this case performed three separate analyses: a comparable public company analysis, a comparable acquisitions analysis, and a discounted cash flow analysis. *Id.* The Examiner determined that the debtor was solvent at the time of the recapitalization under all but one of the relevant formulations, and that the one test that indicated insolvency (applying a "southeast sales multiple," i.e., the sales earnings amount for comparable enterprises operating in the southeastern United States only) was "an inappropriate means of measuring the insolvency of [the debtor] and, in any event, should be given less weight than the other valuation standards." *Id.* at 234.

179. See, e.g., *O'Day*, 126 B.R. at 398 ("[G]enerally accepted accounting principles [] do not control a court's decision [on insolvency]."); *In re Roco Corp.*, 701 F.2d 978, 983 (1st Cir. 1983) (same). But see *In re Ohio Corrugating Co.*, 91 B.R. at 438 (holding that generally accepted accounting principles are a reasonable measure of what liabilities ought to be included in the balance sheet, and therefore in solvency analysis).

180. See *Ohio Corrugating Co.*, 91 B.R. at 438; Sharyn B. Zuch & Richard P. Finkel, *Determining Insolvency in Preference and Fraudulent Conveyance Actions*, 20 AM. BANKR. INST. J. 1, 44 n.9 (2001) (discussing differences in proving insolvency, and noting that tax returns and actual sales of assets may be utilized as starting point for valuation, as well as SEC filings); *Hassan v. Middlesex County Nat'l Bank*, 333 F.2d 838, 840 (1st Cir. 1964) ("Insolvency is not always susceptible of direct proof and frequently must be determined by

In addition, the Code's insolvency definition does not control where the trustee or debtor in possession proceeds under § 544(b) of the Code, in which case the applicable state-law definition applies.¹⁸¹ The UFTA provides that a transfer or obligation incurred by a debtor is fraudulent if it was made without receiving reasonably equivalent value and the debtor was insolvent or became insolvent as a result of the transfer or obligation, and that an insider who has received a transfer from an insolvent debtor on an account of an antecedent debt must have "reasonable cause to believe the debtor was insolvent" before liability for a fraudulent transfer will be imposed.¹⁸² This financial test only considers the transferor's present creditors, i.e., creditors existing at the time the transfer is made or the obligation is incurred.¹⁸³ This standard does not require actual knowledge, but only "knowledge of facts that would cause one to investigate, and which investigation would lead to discovery of insolvency."¹⁸⁴ Section 2(d) of the UFTA utilizes the balance sheet test for insolvency, but excludes certain items that are not excluded under § 101(32) of the Code for the purposes of determining insolvency.¹⁸⁵ Under section 2(b) of the UFTA, there is an automatic presumption of insolvency if the transfer occurred during the ninety-day period before bankruptcy, and the creditor must show that the debtor is not paying its debts as they become due to establish the avoidability of the transfer.¹⁸⁶

The UFTA defines a debtor as insolvent "if the sum of the debtor's debts is greater than all of the debtor's assets at fair valuation."¹⁸⁷ If a partnership is involved, both the partnership and each general partner's debts and assets must be considered.¹⁸⁸

the proof of other facts or factors from which the ultimate fact of insolvency on the transfer dates must be inferred or presumed.").

181. See generally Murray, *Creditors' Rights*, supra note 1.

182. UFTA § 5(b).

183. *Id.*

184. See *Herald Publ'g Co. v. Barberino*, No. CV 93-0454680S, 1993 Conn. Super. LEXIS 3124, at *10 (Conn. Super. Oct. 27, 1993) ("[I]t is not the actual knowledge of the insolvency that is important but the knowledge of facts which would cause one to investigate and which investigation would lead to a discovery of insolvency.").

185. UFTA section 2(d) excludes certain exempt assets that were "transferred, concealed, or removed with intent to hinder, delay, or defraud creditors. . . ."

186. *Id.*

187. UFTA § 2(a). See *United States v. Westley*, No. 98-6054, 2001 U.S. App. LEXIS 6233, at *19-20 (6th Cir. 2001) (ruling that liquidation of debtor's assets and distribution of those assets to another corporation constituted a fraudulent conveyance under the Tennessee UFTA because these actions left debtor insolvent and unable to pay its taxes); *Berland v. Mussa* (*In re Mussa*), 215 B.R. 158, 172 (Bankr. N.D. Ill. 1997) (noting that "[i]nsolvency occurs [under the UFTA] when the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation").

188. UFTA § 2(b).

Based on this definition, a determination of whether a transferor is solvent at the time of, and not rendered insolvent by, a transfer technically would require a "fair value" appraisal of all of the transferor's tangible and intangible assets, including "off-balance-sheet" assets such as causes of action against third parties;¹⁸⁹ "booked" liabilities;¹⁹⁰ and "off-balance-sheet" unliquidated and contingent obligations, such as leases, guaranteed indebtedness, and litigation claims including environmental liability.¹⁹¹

The Code's definition of "insolvent" is very similar to the UFTA definition, including the manner in which a partnership's insolvency is determined.¹⁹² Both definitions have been referred to as "balance sheet" tests of insolvency.¹⁹³ However, that is somewhat misleading because as indicated above, under the UFTA definition certain "off-balance-sheet" assets and liabilities are considered and courts consider current "fair value," as opposed to historical "book value," in determining the solvency or insolvency of the debtor.¹⁹⁴ The UFTA definition of "insolvency" contains a

189. *See id.*

190. *See id.*

191. The UFCA's definition of "insolvency" is somewhat different than the UFTA definition. UFCA section 2(1) states that, "[a] person is insolvent when the present fair saleable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured." *See Morgan Guar. Trust Co. v. Hellenic Lines, Ltd.*, 621 F. Supp. 198, 220 (S.D.N.Y. 1985) (stating that under the UFCA, "[i]t is the fair saleable value of assets, not their book value, that determines insolvency. Cash flow is not a factor and an 'inability to pay current obligations as they mature does not show insolvency'"); *CCEC Asset Mgmt. Corp. v. Chem. Bank (In re Consolidated Capital Equities Corp.)*, 175 B.R. 629, 631 (Bankr. N.D. Tex. 1994) (holding that under the California UFCA, "[t]o have been solvent, [the debtor] must have been able . . . to sell its assets at arms length in market sales and pay its liabilities, including probable liability on contingent debts"). Courts have determined that "present fair saleable value" means the value that can be obtained if the assets are sold with reasonable promptness in an existing (not theoretical) market. *See, e.g., Am. Nat'l Bank & Trust Co. v. Bone*, 333 F.2d 984, 986 (8th Cir. 1964) (stating that fair valuation means a value that can be made promptly effective by the owner of the property to pay his debts); *Constructora Maza, Inc. v. Banco de Ponce*, 616 F.2d 573, 577 (1st Cir. 1980) (holding that because determination of fair valuation of debtor's assets is an inexact science, insolvency frequently must be determined by proof of other facts or consideration of other factors from which insolvency may be inferred); *In re Martin*, 145 B.R. 933, 947 (Bankr. N.D. Ill. 1992), *appeal dismissed*, 151 B.R. 154 (Bankr. N.D. Ill. 1992) (ruling that the issue of insolvency must be viewed from the creditors' perspective and not the debtor's); *Util. Stationery Stores, Inc. v. Am. Portfolio (In re Util. Stationary Stores, Inc.)*, 12 B.R. 170, 176 (Bankr. N.D. Ill. 1981) (explaining that fair valuation has been interpreted generally to mean the amount that can be realized from the assets within a reasonable time).

192. 11 U.S.C. § 101(32)(A)-(B).

193. *Am. Insulator Co. v. Marsh Plastics, Inc.*, 60 B.R. 752, 754-55 (Bankr. E.D. Pa. 1986).

194. UFTA § 5(a).

presumption of insolvency that applies to “[a] debtor who is generally not paying his [or her] debts as they become due.”¹⁹⁵ No such statutory presumption of insolvency exists under either the UFCA or § 548 of the Code. In UFTA states, if a seller or borrower is currently not paying creditors, including unsecured creditors, due to cash-flow problems or otherwise, the seller or borrower will be “presumed” insolvent.¹⁹⁶ Therefore, if the seller or borrower is not receiving “reasonably equivalent value” for the transfer, or the transfer is to an insider for an antecedent debt, courts are likely to determine the transfer to be void as a fraudulent transfer.¹⁹⁷

c. The Capitalization Test

Under the UFTA, this financial test involves an analysis of whether the transferor “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.”¹⁹⁸ The UFCA version of this test speaks of conveyances made or obligations incurred by a person engaged or about to engage in a business or transaction when the property remaining in such person’s hands after the conveyance is “an unreasonably small capital.”¹⁹⁹ The Code also uses the “unreasonably small capital” language with regard to this test.²⁰⁰

The Code does not define the phrase “unreasonably small capital.” Instead, the concept of unreasonably small capitalization has been left for judicial determination on a case-by-case basis.²⁰¹

195. 11 U.S.C. § 2(b).

196. See *Fokkena v. Winston*, 189 B.R. 744, 746 (Bankr. N.D. Iowa 1995) (noting that trustee enjoys the presumption of insolvency transfers of money and the mortgage interest were made within ninety days of the bankruptcy filing).

197. See *Pajaro Dunes Rental Agency v. Spitters*, 174 B.R. 557, 573, 595 (Bankr. N.D. Cal. 1994).

198. UFTA § 4(a)(2)(i). See also *In re Jackson*, 318 B.R. at 21 (“[The] evidence demonstrates that after the . . . transfers, even though no actual fraudulent intent was proven, the Debtor’s remaining assets were unreasonably small in relation to the business in which he was engaged prior to and after the transfers.”).

199. UFCA § 5.

200. 11 U.S.C. § 548(a)(1)(B)(ii)(II).

201. See *Vadnais Lumber Supply, Inc. v. Byrne (In re Vadnais Lumber Supply, Inc.)*, 100 B.R. 127, 137 (Bankr. D. Mass. 1989) (“The phrase ‘unreasonably small capital’ is not defined in . . . the [UFCFA]. The [UFTA] substitutes ‘assets’ for ‘capital’ in order to avoid possible confusion with the corporate law concept of capital, funds permanently invested in the business, which has no relevance in fraudulent transfer law.”); *UFTA* § 4, cmt. 4; *Dayton Title Agency, Inc. v. White Family Cos. Inc. (In re Dayton Title Agency, Inc.)*, 292 B.R. 857, 874 (Bankr. S.D. Ohio 2003) (noting that “the party attempting recovery must prove that the debtor transferred an interest in its property for less than reasonably equivalent value leaving it with unreasonably small assets compared to the debtor’s historical level of assets or cash flow and

Unreasonably small capital generally indicates a financial condition short of insolvency and is not the equivalent of insolvency.²⁰² Important factors considered by the courts include the following: (1) whether the debtor's financial difficulties, though short of insolvency, are likely to lead to insolvency at some time in the future; (2) whether the transfer of the debtor's property aggravated, but did not of itself cause, the debtor's unreasonably small capital; (3) whether the debtor's business is able to generate sufficient profits to sustain operations on a continuing basis; (4) the sources of operating capital and the availability of credit; (5) the company's historical data and cash flow needs; (6) the reasonableness of the debtor's cash flow projections, including monthly analyses of the debtor's balance sheet, income statement, net sales, gross profit margins, and net profits and losses; (7) adjustments for difficulties that could reasonably be anticipated, such as interest rate fluctuations and general economic downturns, and the incorporation of some margin for error; and (8) whether the debtor's assets exceed its liabilities by a sufficient margin to provide an adequate "equity cushion."²⁰³

As one court has stated, "[t]his analysis requires a court to

current needs") (citation and internal quotations omitted).

202. See *Pioneer Home Builders, Inc. v Int'l Bank of Commerce* (*In re Pioneer Home Builders, Inc.*), 147 B.R. 889, 894 (Bankr. W.D. Tex. 1992) ("This court shares the views of other courts which have held that unreasonably small capital indicates a financial condition short of insolvency."); *Murphy v. Meritor Sav. Bank* (*In re O'Day Corp.*), 126 B.R. 370, 407 (Bankr. D. Mass. 1991) (noting that "unreasonably small capitalization need not be so extreme a condition of financial debility as to constitute equitable insolvency" (quoting James F. Queenan, *The Collapsed Leveraged Buyout and the Trustee in Bankruptcy*, 11 CARDOZO L. REV. 1, 18 (1989); *Vadnais Lumber Supply*, 100 B.R. at 137 ("Unreasonably small capitalization is not the equivalent of insolvency in either the bankruptcy or the equity sense"). *But see* *Gleneagles Inv. Co.*, 565 F. Supp. at 580 (stating, "a finding of insolvency is ipso facto a finding that the debtor was left with unreasonably small capital after the conveyance"); *Ring v. Bergman* (*In re Bergman*), 293 B.R. 580, 585 (Bankr. S.D.N.Y. 2003) ("[T]he test of 'unreasonably small capital' is 'reasonable foreseeability,' tested by an objective standard anchored in projections of cash flow, sales, profit margins, and net profits and losses, including difficulties that are likely to arise."); *Fabricators, Inc. v. Technical Fabricators, Inc.* (*In re Fabricators, Inc.*), 926 F.2d 1458, 1469 (5th Cir. 1991) ("The concept of undercapitalization normally refers to the insufficiency of the capital contributions made to a corporation. When an insider makes a loan to an undercapitalized corporation, a court may recast the loans as contributions to capital."); *Bruce A. Markell, Toward True and Plain Dealing: A Theory of Fraudulent Transfers Involving Unreasonably Small Capital*, 21 IND. L. REV. 469, 472 (1988).

203. See *Moody*, 971 F.2d at 1075 (holding that because the transaction neither left debtor with unreasonably small capital nor rendered debtor equitably insolvent, it did not constitute a fraudulent transfer). *Cf. In re Lane*, 108 B.R. 6, 7-8 (Bankr. D. Mass. 1989) (holding that the equity cushion theory of adequate protection does not withstand statutory analysis).

examine the ability of the debtor to generate enough cash from operations and sales of assets to pay its debts and remain financially stable.”²⁰⁴ Another court has stated that, with respect to the relationship between insolvency and unreasonably small capital, “the better view would seem to be that ‘unreasonably small capital’ denotes a financial condition short of equitable insolvency.”²⁰⁵ Some courts have held that the question concerning adequacy of capital after the challenged transfer should be judged prospectively from the date of transfer.²⁰⁶ For example, the analysis begins with the transfer and then examines the relationship, if any, between the amount of capital remaining in the business in the period after the transfer, and the business’ ability to continue operations during that period in the same manner as it conducted them before the transfer.²⁰⁷

The basic question posed by this financial test is: Will the transferor (seller or borrower) be left with “unreasonably small capital” after the transaction being insured has been

204. *Vadnais Lumber Supply*, 100 B.R. at 137. The court in *Vadnais* applied a “cash flow” test instead of a “valuation of assets” test. *Id.*

205. *Moody*, 971 F.2d at 1064. See Queenan, *supra* note 202, at 18 (noting that “[u]nreasonably small capitalization need not be so extreme a condition of financial debility as to constitute equitable insolvency, which is an inability to pay debts as they mature,” and that the term “encompasses financial difficulties which are short of equitable or bankruptcy insolvency but are likely to lead to some type of insolvency eventually”). See also *In re PWS Holding Corp.*, 228 F.3d 224, 233 (3d Cir. 2000). The court stated that:

[T]he viability of the claims depends on whether the [leveraged] recapitalization left [the debtor] insolvent or with an unreasonably small amount of assets in relation to the business or the transaction. If the value of the assets acquired in the recapitalization does not exceed the debt incurred, or if the business was left with unreasonably small capital, the transaction may be a “fraudulent transfer.”

Id.

206. See, e.g., *Moody*, 971 F.2d at 1071-73 (finding that the district court did not err in considering whether the leveraged buyout left the plaintiff corporation with unreasonably small capital in conjunction with whether it rendered the company equitably insolvent).

207. *Id.* See also *In re PWS Holding Corp.*, 228 F.3d at 234 (noting that “[a]ctual performance of the debtor following the transaction is evidence of whether the parties’ projections were reasonable”); *Murphy*, 126 B.R. at 404-09 (holding that the bank was given false optimism about the creditor’s financial condition); *Widett v. George*, 148 N.E.2d 172, 177 (Mass. 1958) (reasoning that every conveyance made without fair consideration is fraudulent as to creditors and those who become creditors); *Yoder v. T.E.L. Leasing, Inc. (In re Suburban Motor Freight, Inc.)*, 124 B.R. 984, 999 (Bankr. S.D. Ohio 1990) (“Courts’ inquiries must weigh the raw financial data against the nature of the entity and the extent of the entity’s need for capital during the time-frame in question.”). One commentator stated that “the test for unreasonably small ‘capital’ should include . . . all reasonably anticipated sources of operating funds, which may include new equity infusions, cash from operations or cash from secured or unsecured loans over the relevant time period.” Markell, *supra* note 202, at 496.

consummated?²⁰⁸ It may not be sufficient to analyze just the transaction being insured, because courts can and often do take into account other related transactions that are in close proximity to the insured transaction.²⁰⁹ As noted earlier, in these situations the court may “collapse” and consolidate the various related transactions into one for purposes of its fraudulent transfer analysis.²¹⁰ The title insurer often will have no direct or indirect knowledge of those other transactions.

The “unreasonably small capital” test protects both present and future creditors.²¹¹ For that reason, and because there may be other related transactions than just the one being insured, it is practically impossible for the title insurer ever to make a completely accurate determination of whether the transfer may be avoided under this test. This is because financial information obtained from the transferor, regardless of how detailed or accurate, is only a “snapshot” of present information. Future financial and operating performance can only be estimated based on past performance, projected earnings, and other data. Such projections, while important to consider and analyze when underwriting the transaction, are based on historical experience that may not be realized in the future.²¹²

Often an unanticipated future event causes financial difficulty and results in a fraudulent transfer claim. Such unanticipated events might take the form of labor union difficulties, negative public relations, or uninsured tort or environmental claims, which have a negative impact on revenues or result in a sudden and dramatic increase in liabilities. A bankruptcy court that is asked to rule on a fraudulent transfer challenge often is motivated to protect existing creditors—especially unsecured creditors—of the financially distressed seller or borrower.²¹³

208. See *In re PWS Holding Corp.*, 228 F.3d at 240 (“To succeed on a claim of constructive fraudulent transfer arising out of the recapitalization, a claimant would have to show that [debtor] was insolvent or left with unreasonably small capital at the time of recapitalization.”).

209. See *supra* note 163 and accompanying text (noting that allegedly fraudulent transfers cannot be evaluated in isolation, and related transaction should be considered in context).

210. See *Murphy*, 126 B.R. at 394 (noting that “in analyzing the fair consideration requirement . . . in the LBO context, courts not infrequently ‘collapse’ the discrete steps employed by the parties in structuring the transaction”).

211. See *Whitlock v. Hause (In re Hause)*, 13 B.R. 75, 77 (Bankr. D. Mass. 1981).

212. See *In re Casual Male Corp.*, 120 B.R. 256, 264 (Bankr. D. Mass. 1990); *Credit Managers Assoc. v. Fed. Co.*, 629 F. Supp. 175, 187 (C.D. Cal. 1985).

213. See *In re Habegger*, 139 F. 623, 626 (8th Cir. 1905) (“[T]he dominant object and purpose [of the Bankruptcy Act] is to protect the estate of failing debtors and to distribute it among creditors pro rata in proportion to their

d. The Cash Flow Test

Referring to this alternative financial test, the Code speaks of transfers made or obligations incurred if the debtor (transferor) "intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured."²¹⁴ There are relatively few court rulings that deal specifically with this test under § 548. This is probably because such a determination necessarily requires a court to undergo a subjective analysis of a party's intention. Often the court infers such an intention from the facts and circumstances surrounding the transfer.²¹⁵ Evidence of the debtor's general financial history and economic instability at or near the date of the transfer may be significant in this analysis. Other important factors include the debtor's lack of ability to obtain credit or operating capital immediately prior to the challenged transfer, and knowledge and awareness of the debtor's shareholders that the debtor was financially hard pressed at the time.²¹⁶

Under the UFTA, the "cash flow" test involves an analysis of whether the transferor "intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due."²¹⁷ The UFCA version of this test speaks of conveyances made or obligations incurred by a person who "intends or believes that he will incur debts beyond his ability to pay as they mature."²¹⁸

Under the Code, and both the UFTA and UFCA, the title underwriter must ask the following questions with respect to the cash flow test: (1) Will the transferor (seller or borrower) maintain sufficient cash flow to be able to pay his or her (or its) debts as they come due? (2) What is the current cost structure? (3) Are cash flow projections consistent with historical performance and industry trends?

provable demands, to guard it from preferred creditors and fraudulent grantees.").

214. 11 U.S.C. § 548(a)(1)(B)(ii)(III).

215. See *O'Day*, 126 B.R. at 398.

216. See *id.* at 404-05 (noting the fact that debtor was solvent at or after the time of transfer is irrelevant, if debtor intended to incur debts beyond its ability to repay them). See also 5 COLLIER ON BANKRUPTCY ¶ 548.04[2][a], at 548-50 (15th ed. Rev. 2002) (stating that the better view is that the debt is incurred whenever debtor obtains a property interest in the consideration exchanged giving rise to the debt); *Fidelity Trust Co. v. Union Nat'l Bank*, 169 A. 209, 216-18 (Pa. 1933), (noting that debtor was insolvent when the agreement with the bank creditor was executed, which was delivered in response to a request for the bank for additional collateral, and the bank would be held to knowledge that transaction was fraudulent), *cert. denied*, 291 U.S. 680 (1934).

217. UFTA § 4(a)(2)(ii).

218. *Id.* § 6.

Similar to the capitalization test, the cash flow test protects both existing and future creditors.²¹⁹ It therefore presents the same analytical difficulty for title insurers as the capitalization test, i.e., an inability to accurately assess the likelihood of future creditors who could challenge the transfer as fraudulent.

e. *The Title Insurer's Analysis of Constructive Fraud*

In order to be comfortable that a transfer without reasonably equivalent value is not likely void because of constructive fraud, it is necessary for a title insurance underwriter to answer in the negative *all* of the following questions relating to the transferor's financial situation:

- Is the transferor (seller or borrower) insolvent now, or will the transferor be rendered insolvent as a result of the transfer?
- Is the transferor engaged or about to engage in business or a transaction for which its remaining assets are unreasonably small, i.e., will there be a sufficient "equity cushion" after the transfer?
- Has the transferor incurred, or reasonably should have believed it was incurring, debts beyond its ability to pay as they come due?²²⁰

In order to answer the last two questions, the title underwriter must be able to accurately predict the future because each of these financial tests protects both future and present creditors. This is the most problematic aspect of the constructive fraud analysis for a title insurer.

B. Preferential Transfers

The preferential transfer component of the creditors' rights exclusion seeks to make clear that the title insurance policy excludes from coverage any claim that challenges the transaction creating the interest of the insured as a preferential transfer. This exclusion is self-limiting in two respects. It does not apply: (1) to any transfer prior to the transfer creating the insured's interest in the land; or (2) if the basis of the preference challenge is the (a) failure to timely record the transfer instrument (e.g., the deed in connection with an owner's policy or the mortgage in connection with a loan policy), or (b) the recording fails to impart constructive notice of its contents to a purchaser for value or a judgment or lien

219. See *O'Day*, 126 B.R. at 392.

220. In connection with an LBO transaction, the company's insolvency should be examined before and after the transaction, as well as at the time of the transfer. See *Ohio Corrugating Co.*, 91 B.R. at 439-40 (finding that the transaction was not a fraudulent conveyance because plaintiffs failed to prove that the defendant was insolvent at the time of leveraged buyout).

creditor.²²¹

When debtors know that their financial problems are worsening, they often will prefer one creditor to another to keep an essential service or to reduce a debt that is personally guaranteed by a partner or shareholder of the debtor. Therefore, the Code tries to eliminate the potential for creditors to race to improve their positions shortly before a bankruptcy filing.²²² Subject to certain affirmative defenses, a transfer to a creditor is deemed a preference and may be set aside pursuant to § 547(b) of the Code if the transfer was: (1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt; (3) made while the debtor (transferor) was insolvent; (4) made within ninety days of the date a bankruptcy petition is filed or within one year of that date if the transfer was to an insider; and (5) enabled the creditor to receive more than the creditor would receive under a Chapter 7 liquidation proceeding.²²³

The concept of a preferential transfer is a federal bankruptcy law creation. Although the Code prohibits certain types of preferential transfers, there is generally no counterpart to this avoidance power under state law.²²⁴ Such preferences generally

221. The third paragraph of Exclusion 7 contains this exclusion from coverage under the 1992 ALTA Loan Policy.

222. See *Sugarman*, 926 F.2d at 1254.

223. See *Waldschmidt v. Ranier (In re Fulghum Constr. Co.)*, 706 F.2d 171, 172 (6th Cir. 1983) (noting that all five enumerated criteria of § 547(b) must be satisfied before a trustee may avoid any transfer of property as a preference), *cert. denied*, 464 U.S. 935 (1983); *Advo-System, Inc. v. Maxway Corp.*, 37 F.3d 1044, 1047 (4th Cir. 1994) (stating that two major policy objectives are achieved by § 547(b), the first being "the avoidance power promotes the 'prime bankruptcy policy of equality of distribution among creditors' by ensuring that all creditors of the same class will receive the same pro rata share of the debtor's estate," and second, "the avoidance power discourages creditors from attempting to outmaneuver each other in an effort to carve up a financially unstable debtor and offers a concurrent opportunity for the debtor to work out its financial difficulties in an atmosphere conducive to cooperation"); *Lindquist v. Dorholt (In re Dorholt, Inc.)*, 224 F.3d 871, 872-73 (8th Cir. 2000) ("The Bankruptcy Code allows the trustee to avoid (set aside) pre-bankruptcy transfers of the debtor's property that would result in preferential treatment of favored creditors."). When considering the adoption of § 547, Congress identified three goals for the preference section of the Code: "First, it lessens the possibility of a scramble among creditors for advantage; second, it promotes equality [of distribution among creditors]; and third, it eliminates the incentive to make unwise loans in order to obtain a preferential payment or security." H.R. DOC. NO. 93-137, at 202 (1973) (Report of the Commission on the Bankruptcy Laws of the United States). See *Barash v. Pub. Fin. Corp.*, 658 F.2d 504, 507 (7th Cir. 1981) (stating that the creditor's knowledge or state of mind is no longer relevant). See also H.R. REP. NO. 95-595, at 10 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 5970 (noting that courts will have to determine value on a case-by-case basis, taking into account the facts of each case and the competing interests in the case).

224. Both the UFCA (section 3(b)) and the UFTA (section 3 (a)) allow a

are not prohibited by state law (although some states do provide a basis to challenge transfers to "insiders"). In fact, state law may expressly permit a debtor to prefer one creditor over another.²²⁵ Of the forty states that have adopted the UFTA, thirty-six have adopted it with section 5(b), which provides that a transfer by the debtor is fraudulent, and recoverable under state law, if it was made to an insider for an antecedent debt, the debtor was insolvent at the time, and the insider had reasonable cause to believe that the debtor was insolvent.²²⁶ An action to recover an insider preference must be initiated within one year after the transfer was made or the obligation was incurred.²²⁷

Certain transactions raise preference issues, such as the granting or substitution of new or additional security (including a mortgage to a particular pre-existing creditor with no additional funds or other consideration flowing from the creditor) in order to delay or avoid foreclosure or to prevent the exercise of other creditor remedies by the creditor.²²⁸ Also, cross-collateralizing and cross-defaulting existing independent mortgages from a single borrower who is insolvent could result in a preferential transfer, if the value of all of the properties secured exceeds the amount previously secured by the independent mortgage. One of the most common forms of preferential transfer is using the proceeds of a new secured loan to repay an existing unsecured loan with the same lender.²²⁹

debtor to pay a creditor to secure or satisfy an antecedent debt.

225. See, e.g., CAL. CIV. CODE § 3432 (West 2004) (providing that "[a] debtor may pay one creditor in preference to another, or may give to one creditor security for the payment of his demand in preference to another"). See also *Blumenstein v. Phillips Ins. Ctr., Inc.*, 490 P.2d 1213, 1222 n.12 (Alaska 1971) (noting that "[a]n exhaustive list of cases upholding the right of a debtor to prefer one among his creditors would require far too much space for inclusion in this opinion"); *Berger Furnace Co. v. Collins*, 92 N.W.2d 338, 340 (Mich. 1958) (noting that under Michigan law, "a debtor may prefer one creditor to another"); *Mason v. Mason*, 296 N.W. 703, 705 (Mich. 1941) (stating that "[t]here is no question that in this State a debtor can prefer one creditor to another, although at the time of such preference, the debtor may be insolvent"); *Warner v. Littlefield*, 50 N.W. 721, 724 (Mich. 1891) (noting that an insolvent debtor may "secure a creditor for the payment of a pre-existing debt by a mortgage upon all his property, although he may have numerous other creditors who are unsecured").

226. UFTA § 5(b).

227. *Id.* § 9(c). See Lisa Sommers Gretchko, *Uniform Fraudulent Transfer Act Makes Insider Preferences Creatures of State Law*, 18 AM. BANKR. INST. J. 29 (1999) (discussing use of UFTA section 5(b) to facilitate workouts and settlements).

228. See *Mfrs. & Traders Trust Co. v. Goldman (In re Ollag Constr. Equip. Corp.)*, 578 F.2d 904, 905 (2d Cir. 1978) (stating that "when financial storms rage, unsecured creditors take on collateral as ballast").

229. See *Hill v. SE Bank (In re Continental Country Club, Inc.)*, 108 B.R. 327, 330-31 (Bankr. M.D. Fla. 1989).

Other structures that can result in preference challenges include providing substitute security of greater value than the existing security when the lender is under-secured by its existing security and transferring assets to an insider to repay an obligation owed to the insider. Delayed recording of a mortgage can also constitute a preference, but as noted above, this basis for challenging a transfer is excepted from the creditors' rights exclusion. But if the recording function is not handled by the title insurer (or its authorized policy-issuing agent) a preference challenge for failure to timely record may fall under another applicable policy exclusion from coverage, such as the "created, suffered, assumed or agreed to" exclusion.²³⁰

The same definition of "insolvency" that applies to the Code's fraudulent transfer provisions applies in a preference action.²³¹ But in a preference action the trustee or DIP is aided by a presumption of insolvency contained in § 547(f) during the ninety-day "preference period" preceding the date of filing the petition.²³² As a result, every preferential transfer is at risk of being voided if a bankruptcy petition is filed within ninety days of the transfer. The creditor has the initial burden of proving that the debtor was

230. See paragraph 3(a) of the Exclusions from Coverage section of the 1992 ALTA Owner's and Loan Policies.

231. As set forth in § 101(32) of the Code, "insolvent" means that the sum of the debtor's debts is greater than all of the debtor's assets measured on the basis of "fair value" (as opposed to "book value"). "Insolvency" for preference purposes is rebuttably presumed during the period ninety days before the commencement of a bankruptcy proceeding. 11 U.S.C. § 547(f). Insolvency is a question of fact, proof of which is determined by the preponderance of the evidence, and is determined by courts on a case-by-case basis. The burden of persuasion is on the trustee or DIP to establish solvency. See, e.g., *Trans World Airlines v. Travellers Int'l A.G.*, 180 B.R. 389, 410 (Bankr. D. Del. 1994) (stating that "[a]ccounting conventions are not the controlling principles for the legal determination of whether a debtor's debts exceed the fair value of its assets for purposes of insolvency"); *Lids Corp. v. Marathon Inv. Partners, L.P.* (*In re Lids Corp.*), 281 B.R. 535, 543-44 (Bankr. D. Del. 2002) (holding that in a preference avoidance action, if a transferee presents sufficient evidence to rebut the statutory presumption of insolvency, the burden shifts to the debtor to establish insolvency and ruling that a presumption of insolvency was not overcome based on amount of debt, which must be measured at face value; and noting further that "market multiple methodology" is an acceptable technique for determining debtor's insolvency for preference purposes). In *Sierra Steel, Inc. v. Totten Tubes, Inc.* (*In re Sierra Steel, Inc.*), 96 B.R. 275, 278-79 (9th Cir. 1989), the court ruled that the transfer was not a preference under § 547 of the Code because generally accepted accounting principles are not controlling in determining insolvency, and it was not erroneous for the bankruptcy court to remove a contingency claim from the insolvency analysis since it had no value. The court applied a strict "balance sheet" analysis to determine insolvency and stated that "a debtor is insolvent when its liabilities exceed its assets." *Id.* at 277. See also *Zuch & Finkel*, *supra* note 180, at 44 (discussing difficulties in proving insolvency).

232. 11 U.S.C. § 547(f).

solvent when the transfer occurred.²³³

The title underwriter must identify whether there is a preference issue present in the transaction. The underwriter will look for any indication that a creditor is receiving a transfer, or a benefit from a transfer, because of an antecedent debt or obligation that gives the creditor more than it would receive in a liquidation proceeding under Chapter 7 of the Code.²³⁴ The most frequently encountered preference issues arise in mortgage loan transactions where some or all of the loan proceeds are being disbursed to pay off or pay down unsecured debt owed to the same lender who is funding the new secured loan. This issue is particularly troublesome when the lender to be insured is also the existing creditor, whose unsecured loan is being paid with the proceeds of the new secured loan. This is a classic form of preferential transfer. The key to this analysis, as it is with the fraudulent transfer analysis applied to a loan transaction, is to "follow the money."

1. What Constitutes a "Transfer?"

Under § 101(54) of the Code, the definition of "transfer" is very broad, and would include a cash payment to the creditor as well as the perfection of a security interest or the obtaining of a lien.²³⁵ The question of what constitutes a transfer and when the transfer is complete for preference purposes is a matter of federal law.²³⁶

In *In re FIBSA Forwarding, Inc.*,²³⁷ a Texas bankruptcy court held that the Supreme Court's ruling in *BFP*²³⁸ should be applied to nullify a challenge to a real estate foreclosure sale on the basis that it constituted a preferential transfer. The court conceded that a foreclosure sale constituted a "transfer" under § 101(54) of the

233. See *Rice v. First Ark. Valley Bank (In re May)*, 310 B.R. 405, 416 (Bankr. E.D. Ark. 2004) ("Though a debtor is presumed insolvent during the preference period . . . if the creditor produces evidence of solvency, the debtor has the ultimate burden of proof.") (citation and internal quotations omitted). All elements under § 547 must be proven by a preponderance of the evidence. See, e.g., *In re First Software Corp. v. Computer Assoc. Int'l*, 107 B.R. 417, 421 (Bankr. D. Mass. 1989); *Meyers v. Vt. Nat'l Bank (In re Music House, Inc.)*, 11 B.R. 139, 140 (Bankr. D. Vt. 1980); *Glinka*, 130 B.R. at 182. But see *In re Cleveland Graphic Reprod., Inc.*, 78 B.R. 819, 822 (Bankr. N.D. Ohio 1987) (applying a "clear and convincing" evidentiary standard).

234. See *Gov't Sec. Corp. v. Camp (In re Gov't Sec. Corp.)*, 972 F.2d 328, 330-31 (11th Cir. 1992).

235. 11 U.S.C. § 101(54).

236. See *Chambers v. Pickard (In re Lewis)*, 237 B.R. 506, 508 (Bankr. M.D. Fla. 1999) (noting that "although [the] definition [of transfer under the Code] is very broad, certain limits exist").

237. 230 B.R. 334 (Bankr. S.D. Tex. 1999).

238. See *supra* note 117 and accompanying text.

Code.²³⁹ The court also acknowledged that the debtor became insolvent as the result of the bankruptcy sale, but ruled that in making a preference analysis, it should look only to whether the debtor was insolvent just prior to the transfer because there is no language in § 547 that requires the court to determine whether the debtor was “rendered insolvent” by the alleged preferential transfer.²⁴⁰

Presumably, in a Chapter 7 bankruptcy liquidation, a secured creditor would receive the property and be credited with its fair market value.²⁴¹ This “liquidation value” test is different than the “reasonably equivalent value” test discussed above.²⁴² The *In re FIBSA Forwarding* court concluded, however, that it should make the same determination under the liquidation test as the Supreme Court did in *BFP* with respect to its reasonably equivalent value analysis, i.e., whether a regularly conducted, non-collusive foreclosure sale had occurred in accordance with state law requirements.²⁴³ The bankruptcy court reasoned that although the Supreme Court’s ruling in *BFP* was not directly on point, the rationale was the same, and the Court in *BFP* had held that in a foreclosure setting involving a distressed sale, reasonably equivalent value could not be determined by reference to fair

239. See *In re FIBSA Forwarding*, 230 B.R. at 337.

240. *Id.* at 337-38. See also *Cottrell v. United States (In re Cottrell)*, 213 B.R. 33, 43 (Bankr. M.D. Ala. 1997) (affirming a bankruptcy court decision that found the *BFP* rationale equally applicable to both § 547 and § 548). Cf. *Rambo v. Chase Manhattan Mtg. Corp. (In re Rambo)*, 297 B.R. 418, 432 (Bankr. E.D. Pa. 2003) (“Under fraudulent conveyance law, the state-prescribed foreclosure sale determines how the property has to be sold. In the preference contest [sic], it is the federal bankruptcy-prescribed sale by a Chapter 7 trustee that is determinative.”); *Glaser v. Chelec, Inc. (In re Glaser)*, No. 01-10220-SSM, 2002 Bankr. LEXIS 1816, at *34 (Bankr. E.D. Va. Oct. 25, 2002) (“[M]ost courts have held that a secured creditor which acquires real estate by virtue of being the high bidder at a regularly conducted, non-collusive foreclosure sale has not received an avoidable preference simply because the property was worth more than the debt.”). But see *Norwest Bank Minn., N.A. v. Andrews*, 262 B.R. 299, 306 (Bankr. M.D. Pa. 2001) (rejecting *BFP* as binding precedent for determining whether foreclosure sale can be avoided as a preference under § 547(b)); *JP Morgan Chase Bank v. Rocco (In re Rocco)*, 319 B.R. 411 (Bankr. W.D. Pa. 2005) (distinguishing *Norwest Bank Minn.* on the basis that the record in this case did not support a finding that the lender’s claim was “substantially less” than the fair market value of the debtor’s residence); *In re Robinson*, No. 02-16940DWS, 2002 Bankr. LEXIS 1380, at *5 n.5 (“The case law is divided on whether § 547 can be utilized to avoid a sheriff’s sale.”). See generally Craig H. Averch & Blake L. Berryman, *Mortgage Foreclosure as a Preference: Does BFP Protect the Lender?*, 7 J. BANKR. L. & PRAC. 281, 288-89 (1998) (arguing that *BFP* does not apply to preferences because it merely holds that the operative legal standard under 548, “reasonably equivalent value,” is ambiguous).

241. *In re FIBSA Forwarding*, 230 B.R. at 338.

242. *Id.*

243. *Id.* at 340.

market value because to do so would upset the balance between foreclosure law and fraudulent transfer law.²⁴⁴ Thus, the bankruptcy court reasoned that in a properly conducted foreclosure sale the mortgaged property is conclusively presumed to have been sold for its liquidation value.²⁴⁵ The court reached this conclusion even though it acknowledged that the secured creditor had resold the property within a matter of weeks after the foreclosure sale for a substantially greater sum than it had bid at the foreclosure sale to obtain the property.²⁴⁶

2. *The Deprizio Issue*

Section 101(31) of the Code defines "insider," as to whom the "preference period" is one year from the transfer date, to include: (1) For individual debtors, (a) any relative of the debtor or of any general partner of the debtor, (b) a partnership in which the debtor is a general partner, (c) a general partner of the debtor, or (d) a corporation in which the debtor is a director, officer, or person in control; (2) for corporate debtors, (a) any director, officer, or person in control of the debtor, (b) a partnership in which the debtor is a general partner, general partner of the debtor, or relative of a general partner, director, officer, or person in control of the debtor; and (3) for partnership debtors, (a) any general partner in the debtor, (b) any relative of a general partner in, general partner of, or person in control of the debtor, or (c) a partnership in which the debtor is a general partner, general partner of the debtor, or person in control of the debtor.²⁴⁷

If the transfer is made to or benefits an insider, as defined in § 101(31) of the Code, provided that the debtor was insolvent at the time of the transfer and that the transfer gives the creditor more than the creditor would obtain in a Chapter 7 liquidation absent the transfer, the debtor may set aside, under § 547 of the Code, any such transfer that occurred within one year prior to the bankruptcy filing.²⁴⁸ Typically, only unsecured creditors receive preferential transfers because fully secured creditors would receive full payment in a Chapter 7 liquidation unless their security interests were granted during the preference period.²⁴⁹ If the transfer is set aside, the debtor and the creditor are put back in the position that they held prior to the transfer.²⁵⁰

244. *Id.*

245. *Id.*

246. *Id.* at 336.

247. 11 U.S.C. § 101(31).

248. Section 5(b) of the UFTA (as adopted by thirty-six of the forty jurisdictions that have enacted the UFTA) provides a right of recovery with respect to a transfer to an insider under certain conditions. UFTA § 5(b).

249. 11 U.S.C. § 547.

250. *Id.*

Section 202 of the Bankruptcy Reform Act of 1994²⁵¹ ("1994 Reform Act") amended § 550 of the Code.²⁵² The amendment to § 550 was intended to overrule *Levit v. Ingersoll Rand Finance Corp.*²⁵³ ("*Deprizio*") and its progeny. Under the rule of *Deprizio*, courts extend the preference avoidance period from ninety days to a full year for non-insider creditors when the transfers in question nevertheless benefit an insider.²⁵⁴ In particular, *Deprizio* permitted the bankruptcy trustee to recover preferential payments, under §§ 547 and 550 of the Code, consisting of loan payments made to non-insider lenders during this extended one-year preference period when the debt was guaranteed by insiders of the debtor.²⁵⁵ The Seventh Circuit reasoned that even though the preferential payments were not made to the insiders, they were for the benefit of the insider creditors, because each payment made to the lenders reduced, on a dollar-for-dollar basis, the liability of the guarantors to the lenders.²⁵⁶

Section 202 of the 1994 Reform Act expressly intended to overrule *Deprizio* by stating that payments to a non-insider lender may only be recovered if made during the ninety-day period following such payments. Section 202 added the following subsection (c) to § 550 of the Bankruptcy Code:

If a transfer made between 90 days and one year before the filing of the petition —

(1) is avoided under Section 547(b) of this title; and

(2) was made for the benefit of a creditor that at the time of such transfer was an insider; the trustee may not recover under subsection (a) from a transferee that is not an insider.²⁵⁷

However, in *Roost v. Associates Home Equity Services, Inc.*,²⁵⁸ an Oregon bankruptcy court upheld the claim of the trustee that an alleged preferential transfer involving the security interest of

251. Pub. L. No. 103-394, § 202, 108 Stat. 4106, 4121 (1994).

252. 11 U.S.C. § 550. Section 550 provides that the trustee may recover transferred property for the benefit of the estate (or the value of such property if the court orders) from the initial transferee or the entity for whose benefit the transfer was made, or any intermediate or mediate transferee of the initial transferee, unless certain exceptions apply. *Id.*

253. *In re V.N. Deprizio Constr. Co.*, 874 F.2d 1186 (7th Cir. 1989).

254. *Id.* at 1200-01.

255. *Id.* at 1197. Under § 101(31) of the Code, an insider is one who is a principal of, or related to, or affiliated with the debtor. 11 U.S.C. § 101(31).

256. *Deprizio*, 847 F.2d at 1200.

257. The relevant legislative history with respect to this section states that: "This section overrules the *Deprizio* line of cases and clarifies that non-insider transferees should not be subject to the preference provisions of the Bankruptcy Code beyond the 90-day statutory period." 140 CONG. REC. H10752, H10767 (1994).

258. *In re Williams*, 234 B.R. 801, 803 (Bankr. D. Or. 1999).

the defendant in the debtor's mobile home was for the benefit of the debtor's wife, an insider, and that the trustee could avoid the perfection of the security interest under the *Deprizio* rationale.²⁵⁹

The sole issue presented to the court was whether or not the trustee's claim was barred by the 1994 amendments to § 550 of the Code.²⁶⁰ The defendant argued that the 1994 amendments prevented the trustee from recovering the transferred property from a "non-insider creditor," and that the adversary proceeding brought by the trustee should be dismissed.²⁶¹ The trustee in *Williams* relied on *Deprizio* and the line of subsequent court decisions that have adopted its reasoning.²⁶²

The lender in *Williams* argued that because the defendant was a non-insider creditor, the 1994 Reform Act amendment to § 550 barred any recovery by the trustee.²⁶³ The trustee conceded that it could not "recover" any transferred property, but argued that no recovery was necessary in this case because the debtor's interest in the property became property of the bankruptcy estate upon the filing of the debtor's bankruptcy petition.²⁶⁴ Therefore, the trustee asserted, there was nothing to recover and no need to seek the remedies provided by § 550.²⁶⁵ The trustee maintained that the defendant's security interest had been avoided pursuant to § 547(b), and that such avoidance provides a remedy separate and distinct from the right to "recover" transferred property under § 550.²⁶⁶ The trustee also argued that under § 551, the avoided lien was preserved for the benefit of all creditors of the estate.²⁶⁷ The trustee noted that this was not a situation where the property had been transferred to the creditor or a third party prior to the bankruptcy filing, in which event the trustee's remedy would be to seek recovery under § 550.²⁶⁸ The trustee pointed out that the debtor and his wife were in possession of the mobile home at the time of the filing of the debtor's bankruptcy petition, and had continuously remained in possession of the property.²⁶⁹

259. *Id.* at 805. The parties in *Williams* had acknowledged that the perfection of the security was at least "of some potential benefit" to the debtor's wife, the insider. *Id.* at 803.

260. *Id.* at 802-03.

261. *Id.* at 803.

262. *See, e.g.*, Official Unsecured Creditors Comm. v. United States Nat'l Bank (*In re Suffola, Inc.*), 2 F.3d 977, 982 (9th Cir. 1993) (noting the court's agreement with the *Deprizio* case).

263. *Williams*, 234 B.R. at 802.

264. *Id.* at 803-04.

265. *Id.* at 804.

266. *Id.* at 803-04.

267. *Id.* at 804; 11 U.S.C. § 551. Under § 551, any transfer avoided under certain sections of the Code, including §§ 547, 548, and 549, is "preserved for the benefit of the estate but only with respect to property of the estate."

268. *Williams*, 234 B.R. at 804.

269. *Id.*

The court noted that this was a case of first impression.²⁷⁰ Although acknowledging the split of authority among commentators and the few bankruptcy courts that have dealt with the issue as to whether § 547 of the Code provides a separate remedy from the right to “recover” under § 550, the court agreed with the trustee’s position.²⁷¹

The *Williams* decision confirms several commentators’ belief that negative consequences for lenders may still exist notwithstanding the addition of subsection (c) to § 550. These commentators have expressed their concern that section 202 of the 1994 Reform Act eliminated only the right to *recover* the preference and that the preference may still be avoidable, notwithstanding the clear intention of Congress to overrule the *Deprizio* line of cases and to protect non-insider transferees for transfers received more than ninety days prior to the bankruptcy filing.²⁷²

The *Williams* decision may prompt Congress to attempt to close the “loophole” in the existing language of §§ 547 and 550 exposed by the court in *Williams*. Although Congress’s intention in enacting section 202 of the 1994 Reform Act may have been to prevent recovery of all payments to non-insider creditors outside of the ninety-day preference period, case law has not uniformly

270. *Id.* at 803.

271. *Id.* at 804. See also *Suhar v. Burns (In re Burns)*, 322 F.3d 421, 423-24 (6th Cir. 2003) (affirming a ruling of the Sixth Circuit Bankruptcy Appellate Panel, which held that § 550 was not applicable to an avoided mortgage because the trustee had not sought recovery of any property or its value from mortgage lender); John C. Murray, *DePrizio Lives (in a Mobile Home in Oregon)*, AM. BANKR. INST. J., Oct. 18, 1999, at 14. But see *In re Black & White Cattle Co.*, 783 F.2d 1454, 1462 (9th Cir. 1986) (ruling that holder of an avoided non-possessory interest could invoke benefits of §550, and that § 550 applies even when the plaintiff is seeking merely to avoid a transfer under § 547 and not to recover money or property under § 550; the court stated that “there is nothing in the statute or case law to suggest that Congress meant only transferees in possession”); *Helbling v. Krueger (In re Krueger)*, No. 98-18686, 2000 Bankr. LEXIS 723, at *14 (Bankr. N.D. Ohio June 30, 2000) (criticizing the court’s holding in *Williams* and stating that “*Williams* is flatly inconsistent with the holding in *Black & White Cattle Co.*”); John R. Clemency & LaShawn D. Jenkins, *Deprizio Can’t Be Invoked to Apply the Insider Preference Period to Outside Creditors, Period*, 22 AM. BANKR. INST. J. 25 (2003).

272. See generally Adam A. Lewis, *Did It or Didn’t It? The DePrizio Dilemma*, 14 AM. BANKR. INST. J. 20 (1995); *Bankruptcy: Avoidance of Insider Preferences*, REAL EST. L. REP., Sept. 29, 1999, at 1; Richard C. Josephson, *The Deprizio Override: Don’t Kiss Those Waivers Goodbye Yet*, 4 BUS. L. TODAY 40 (1995) (cited by the court in *Williams* in support of its holding); Robert Millner, *Is DePrizio Dead . . . or Just Wounded? Lien Avoidance as a Post-Reform Act Remedy for Trilateral Preferences*, LENDER LIABILITY NEWS, May 19, 1995, at 12-13; Lawrence Ponoroff, *Now You See It, Now You Don’t: An Unceremonious Encore for Two-Transfer Thinking in the Analysis of Indirect Preferences*, 69 AM. BANKR. L. J. 203 (1995).

recognized this intention and Congress now realizes the need to specifically amend § 547 of the Code. As the *Williams* court noted, "the most effective method would have been to add another defense or exception to avoidance in section 547(c)."²⁷³

3. Statutory Exceptions

Section 547(c) of the Code provides that the trustee or DIP may not avoid transfers that would otherwise be preferential if the creditor can establish that certain enumerated affirmative defenses apply.²⁷⁴ Under § 547(c)(1), if there was a "substantially" contemporaneous exchange for new value given to the debtor, the transfer will not be deemed preferential.²⁷⁵ To prevail, the creditor must demonstrate that: (1) the parties intended the transfer to be a contemporaneous exchange for new value; (2) the exchange was in fact simultaneous; and (3) new value was in fact given.²⁷⁶ Transactions that would otherwise constitute preferential transfers may also fall under the "ordinary course of business" exception provided in § 547(c)(2).²⁷⁷

To qualify for this exception, the transfer must have been (1) made in payment of a debt incurred in the ordinary course of business of both parties; (2) made in the ordinary course of business of both parties; and (3) made according to ordinary

273. *Williams*, 234 B.R. at 805.

274. 11 U.S.C. § 547(c).

275. *Id.*

276. See *Stevenson v. Leisure Guide of Am., Inc. (In re Shelton Harrison Chevrolet, Inc.)*, 202 F.3d 834, 837 (6th Cir. 2000) (stating the three elements for a contemporaneous exchange); *In re Spada*, 903 F.2d 971, 973 (3d Cir. 1990) (allowing some new value to be added in calculation); *Dye v. Rivera (In re Marino)*, 193 B.R. 907, 912 (B.A.P. 9th Cir. 1996) (summarizing requirements of § 547(c)(1)); *In re Jet Fla. Sys., Inc.*, 861 F.2d 1555, 1559 (11th Cir. 1988) (noting that modification of an existing obligation may constitute new value, but a specific calculation of the new value exchanged is required). See also *Jones Truck Lines v. Cent. States SE & SW Areas Pension Fund (In re Jones Truck Lines)*, 130 F.3d 323, 326 (8th Cir. 1997) ("Contemporaneous new value exchanges are not preferential because they encourage creditors to deal with troubled debtors and because other creditors are not adversely affected if the debtor's estate receives new value."); Keith M. Baker, *Trustee Beware: The Defenses to the Preference Claim (Part 1)*, 20 AM. BANKR. INST. J. 1, 6 (2001) (noting that this defense applies only to the extent of the amount of new value given by the creditor).

277. The Code does not define either "ordinary course of business" or "according to ordinary business terms." The legislative history with respect to § 547(c)(2) states that, the "purpose [of the ordinary course of business] exception is to leave undisturbed normal financial relations, because [this exception] does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy." S. REP. NO. 95-989, at 88 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5874.

business terms.²⁷⁸ The determination is factual, and the creditor has the burden of proving, by a preponderance of the evidence, that the transfer is not avoidable because all of the elements of the exception apply.²⁷⁹ Section 547(c)(3) of the Code provides that the trustee or DIP cannot avoid a transfer of a security interest in property to the extent that the otherwise preferred creditor gave contemporaneous “new value” to enable the debtor to acquire the property.²⁸⁰

C. Equitable Subordination

Exclusion 7(b) of the 1992 ALTA Loan Policy excludes from coverage any claim for loss that arises by reason of “the

278. 11 U.S.C. § 547(c)(2).

279. See 4 COLLIER ON BANKRUPTCY ¶ 547.10, at 547-51 (15th ed. 1990); Jeffrey Bigelow Design Group v. First Am. Bank of Md. (*In re Jeffrey Bigelow Design Group, Inc.*), 956 F.2d 479, 486 (4th Cir. 1992) (noting that “courts testing a transfer for ‘ordinariness’ under section 547(c)(2) have generally focused on the prior conduct of the parties, the common industry practice, and, particularly, whether payment resulted from any unusual action by either the debtor or creditor”); Energy Coop., Inc. v. SOCAP Int’l, Ltd. (*In re Energy Cop, Inc.*), 832 F.2d 997, 1004 (7th Cir. 1987) (discussing protections afforded by § 547(c)(2)); R.M. Taylor, Inc. v. Employers Ins. of Wausau (*In re R.M. Taylor, Inc.*), 245 B.R. 629, 637 (Bankr. W.D. Mo. 2000) (stating elements of § 547(c)(2) as they relate to this particular case); *In re Pittsburgh Cut Flower Co.*, 124 B.R. 451, 460-61 (Bankr. W.D. Pa. 1991) (discussing and analyzing the elements of the Section 547 (c)(2) exception); First Software Corp. v. Curtis Mfg. Co. (*In re First Software Corp.*), 81 B.R. 211, 213 (Bankr. D. Mass. 1988) (holding that in order to ascertain whether transfer was made in ordinary course of business, court must engage in “peculiarly factual” analysis); Keith M. Baker, *Trustee Beware: The Defenses to the Preferences Claim (Part Two)*, 20 AM. BANKR. INST. J. 1 (2001).

280. 11 U.S.C. § 547(c)(3). *But see* Claybrook v. SOL Bldg. Materials Corp. (*In re U.S. Wood Products, Inc.*), No. 00-3198, 2004 Bankr. LEXIS 520, at *8 (Bankr. D. Del. Apr. 22, 2004) (“[A] transfer in payment of an antecedent debt does not constitute ‘new value.’”). Section 547(c)(3)(B) provides that the security interest must be “perfected on or before 20 days after the debtor receives possession of such property,” and § 547(c)(3)(A)(i) provides that the new value cannot be given prior to the execution of a security agreement containing a description of the secured property. See *Williams v. Agama Sys., Inc.* (*In re Micro Innovation Corp.*), 185 F.3d 329, 336 (5th Cir. 1999) (noting that “[a] key justification for the new value exception is that while the payment of preferences to the creditor diminished the estate, other creditors are not really worse off, since the subsequent advance of new value replenishes the estate”); *Dye*, 193 B.R. at 915-16 (applying § 547(c) to non-purchase money security agreements and holding that where delay in recording non-purchase money security interest was caused solely by county clerk’s failure to timely record the interest, transfer would be protected as a contemporaneous exchange under § 547(c)(1)). Cf. *Ray v. Sec. Mut. Fin. Corp.* (*In re Arnett*), 731 F.2d 358, 363 (6th Cir. 1984) (ruling that a secured creditor that did not timely perfect non-purchase money security interest under § 547(c)(3) was not entitled to affirmative defense of contemporaneous exchange under § 547(c)(1)).

subordination of the interest of the insured mortgagee as a result of the application of the doctrine of equitable subrogation.”²⁸¹ This specific exclusion, not found in the Owner's Policy (because it is inapplicable), relates solely to § 510(c) of the Code, which permits the bankruptcy court (1) to re-order the priorities of creditors and to subordinate on equitable grounds all or part of a lender's allowed claim or interest, (2) to transfer any lien securing a subordinated claim to the bankruptcy estate, or even (3) to disallow the claim entirely, even if no preferential transfer (under section 547 of the Code) or fraudulent conveyance (under § 548 of the Code) occurred.²⁸² The principles of equitable subordination are not set out in the Code, but are defined by case law.²⁸³

Equitable subordination is an extraordinary remedy²⁸⁴ and courts generally have held that the following three conditions must be satisfied before the sanctions of § 510(c) will be imposed:

281. Am. Land Title Ass'n, *Standards & Forms, ALTA Policies & Endorsements, ALTA Loan Policy*, available at <http://www.alta.org/forms/loan.doc> (Oct. 17, 1992).

282. 11 U.S.C. § 510(c).

283. See, e.g., *Pepper v. Litton*, 308 U.S. 295, 305 (1939) (ruling that the bankruptcy court has exclusive jurisdiction over subordination, the allowance and disallowance of claims, and that the court may reject a claim “in whole or in part according to the equities of each case”); *HBE Leasing Corp. v. Frank*, 48 F.3d 623, 634 (2d Cir. 1995) (noting that “[e]quitable subordination is distinctly a power of federal bankruptcy courts, as courts of equity, to subordinate the claims of one creditor to those of others”); *Minn. Corn Processors, Inc. v. Am. Sweeteners, Inc. (In re Am. Sweeteners, Inc.)*, 248 B.R. 271, 280 (Bankr. E.D. Pa. 2000) (“[R]es judicata did not bar the assertion of equitable subordination” because a “claim for equitable subordination is a core bankruptcy proceeding. . . .”); *80 Nassau Assocs. v. Crossland Fed. Sav. Bank (In re 80 Nassau Assocs.)*, 169 B.R. 832, 837 (Bankr. S.D.N.Y. 1994) (“The power to subordinate a claim derives from the Bankruptcy Court's general equitable power to adjust equities among creditors in relation to the liquidation results.”); *O'Day*, 126 B.R. at 412 (“[E]quitable subordination is an equitable remedy available to the Trustee.”); *In re Poughkeepsie Hotel Assocs. Joint Venture*, 132 B.R. 287, 292 (Bankr. S.D.N.Y. 1991) (“The notion of equitable subordination, as embodied in section 510(c), is peculiar to bankruptcy law and an issue which can only be decided in a bankruptcy setting.”); *Randa Coal Co. v. Iron Coal & Coke Co. (In re Randa Coal Co.)*, 128 B.R. 421, 426 (Bankr. W.D. Va. 1991) (noting that a claim for equitable subordination is a core bankruptcy proceeding substantively based in federal bankruptcy law and distinct from a breach of contract); *In re Clamp-All Corp.*, 233 B.R. 198, 210-11 (Bankr. D. Mass. 1999) (holding that the court could, sua sponte, subordinate the claims of creditors who had engaged in “grossly inequitable conduct” and violated “no less than two sections of the Bankruptcy Code and one of Bankruptcy Rules,” to all other non-insider claims under § 510(c)).

284. See *MB L.P. v. Nutri/Sys., Inc. (In re Nutri/System, Inc.)*, 169 B.R. 854, 865 (Bankr. E.D. Pa. 1994) (“Equitable subordination is an extraordinary measure which is not lightly invoked.”); *Fabricators*, 926 F.2d at 1464 (“[E]quitable subordination is an unusual remedy which should be applied only in limited circumstances.”).

(1) the claimant must have engaged in some kind of inequitable conduct;²⁸⁵ (2) the misconduct must have resulted in injury to the bankrupt's creditors or conferred an unfair advantage on the claimant;²⁸⁶ and/or (3) equitable subordination of the claim must not be inconsistent with the provisions of the Code.²⁸⁷ Because equitable subordination is remedial and not penal, the claim generally will be subordinated only to the extent necessary to offset the specific harm that the debtor and its other creditors suffered on account of the alleged inequitable misconduct.²⁸⁸

The types of conduct found by bankruptcy courts to justify equitable subordination include: (1) an "insider" creditor who, despite having full knowledge that the debtor was undercapitalized and insolvent, advances funds to the debtor in the form of loans when no other third party lender would do so; (2) a creditor who engages in conduct tantamount to overreaching; (3) a lender's agent who misrepresents the availability of construction and take-out financing; (4) a secured creditor who misrepresents the debtor's ability to pay trade creditors; and (5) a lender who controls the debtor's manufacturing operation and its cash disbursements and receives a voidable preference.²⁸⁹

Bankruptcy courts generally invoke these sanctions when the lender has engaged in overreaching or lender control, which occurs

285. See *Daugherty*, 144 B.R. at 322-24 (outlining conditions that need to be satisfied before a court will impose such sanctions); *Bank of N.Y. v. Epic Resorts-Palm Springs Marquis Villas, LLC (In re Epic Capital Corp.)*, 290 B.R. 514, 524-25 (Bankr. D. Del. 2003) (ruling that indenture trustee was not entitled to equitable subordination under § 510(c) because non-insider lender did not engage in inequitable conduct); *Farr v. Phase 1 Molecular Toxicology, Inc. (In re Phase-1 Molecular Toxicology, Inc.)*, 287 B.R. 571, 581 (Bankr. D.N.M. 2002) (rejecting plaintiffs' equitable subordination claim because there was no evidence that defendants engaged in inequitable conduct).

286. *Daugherty*, 144 B.R. at 323.

287. *Id.* See *Exide Techs., Inc.*, 299 B.R. at 743-44 (affirming that to state claim for equitable subordination, each of the three required elements must be pled).

288. *Summit Coffee Co. v. Herby's Foods, Inc. (In re Herby's Foods, Inc.)*, 2 F.3d 128, 130-35 (5th Cir. 1993); See also *Benjamin v. Diamond (In re Mobil Steel Co.)*, 563 F.2d. 692, 699-706 (5th Cir. 1977) (discussing the lack of injury to the creditors); *Hoffman v. Astroline Co., Inc. (In re Astroline Communications Co.)*, 226 B.R. 329 (Bankr. D. Conn. 1998) (noting that "[i]f creditor is shown to be an insider of debtor, its conduct is subject to higher level of scrutiny" and insider has the burden of proving good faith and fair dealing); *1236 Dev. Corp. v. Chertoff (In re 1236 Dev. Corp.)*, 188 B.R. 75, 82 (Bankr. D. Mass. 1995) (examining the potentially harmful effects of undercapitalizing a business); *O'Day*, 126 B.R. at 393-94 (noting that lack of consideration can be harmful); *Daugherty*, 144 B.R. at 324 (holding that where the claimant is a fiduciary of the debtor or an insider, the trustee or DIP must only "prove unfairness in transaction: otherwise subordination is proper only in cases of fraud, spoliation or overreaching").

289. See *Daugherty*, 144 B.R. at 325-27 (examining the type of conduct that can be categorized as equitable subordination).

when the lender steps beyond its traditional role and participates in the debtor's business or engages in egregious conduct that justifies the use of the court's equitable powers.²⁹⁰ As mentioned above, in these situations the court may decide to subordinate, recharacterize, or even disallow a transaction.²⁹¹

290. In recent years some bankruptcy courts have permitted general creditors to invoke § 510(c) without any proof of inequitable conduct. *See, e.g., In re Virtual Network Servs. Corp.*, 902 F.2d 1246, 1250 (7th Cir. 1990) (holding that the subordination of non-pecuniary tax law claims of the IRS was warranted even though IRS's actions were within the law; the court reasoned that equitable subordination no longer requires, in all circumstances, a showing of inequitable conduct on the part of a creditor whose claims are to be subordinated); *In re Vitreous Steel Prods. Co.*, 911 F.2d 1223, 1237 (7th Cir. 1990) (ruling that a lower court should consider all circumstances in determining whether the mortgagee's claim should be subordinated to claims of general creditors and holding that, with regard to *Virtual Network*, it would not be necessary to find that the mortgagee engaged in misconduct and that inquiry should focus on "fairness to the other creditors"); *Glinka*, 121 B.R. at 190 (citing *Virtual Network* with approval); *Ferrari v. Family Mut. Sav. Bank (In re New Era Packaging, Inc.)*, 186 B.R. 329, 335 (Bankr. D. Mass. 1995) (citing *Virtual Network* and stating that "[t]his commonly referred to 'no fault equitable subordination' looks to the nature or origin of the claim"; the court also noted that "[w]hile the legislative history states that a bankruptcy court is authorized to subordinate a claim by reason of the claimant's misconduct . . . it also suggests that a bankruptcy court's power to subordinate a claim on equitable grounds is more extensive"); *Burden v. United States*, 917 F.2d 115, 120 (3d Cir. 1990) (holding that proof of inequitable conduct need not be found for the general creditors to be entitled to equitable subordination). *But see United States v. Noland*, 517 U.S. 535, 538 (1996) (rejecting holdings in *Burden* and *Virtual Network*). The bankruptcy court cases cited above, which held that under certain circumstances inequitable conduct need not be shown in order to support a claim of equitable subordination, appear to have been effectively overruled by the U.S. Supreme Court's ruling in *Noland*. *Id.* *See also* *Diasonics, Inc. v. Ingalls*, 121 B.R. 626, 629 (Bankr. N.D. Fla. 1990) (refusing to extend *Virtual Network* reasoning to cases not involving punitive damages); *First Nat'l Bank v. Rafter* (*In re Baker & Getty Fin. Servs., Inc.*), 974 F.2d 712, 719 (6th Cir. 1992) (noting that "[w]e . . . see no cause to expand a fairness standard involving punitive damages to a case such as this one, which involves actual loss claims by all parties"); *Anchor Resolution Corp. v. State Bank & Trust Co. of Conn. (In re Anchor Resolution Corp.)*, 221 B.R. 330, 342 (Bankr. D. Del. 1998) (refusing to subordinate a creditor's claim that was based upon an arm's length agreement between the parties and not in the nature of a penalty; and stating that as result of the U.S. Supreme Court's holding in *Noland*, holdings in cases such as *Virtual Network* and *Burden* "are no longer good law"). *See generally* *Montgomery Ward Holding Corp. v. Robert Shoebird*, 272 B.R. 836, 845 (Bankr. D. Del. 2001) (noting that although some courts recognize "no fault" equitable subordination, "[a] court must 'explore the particular facts and circumstances presented in each case before determining whether subordination of a claim is warranted'" (citation omitted)).

291. In general, the equitable subordination doctrine is limited to reordering priorities, and does not permit total disallowance of a claim. *See 80 Nassau Assocs.*, 169 B.R. at 837 (stating that the equitable subordination doctrine is "limited to reordering priorities, and does not permit disallowance of claims")

Equitable subordination is an equitable remedy available solely to the bankruptcy trustee under the Code, and no similar cause of action exists under either the UFTA or the UFCA. The courts have not been consistent in their treatment of what conduct should result in subordination of a creditor's claim.²⁹² If the creditor's claim has otherwise been found to constitute a fraudulent transfer and its lien is avoided, it would ordinarily still be able to participate in the debtor's estate as a general unsecured creditor.²⁹³ But the court could by invoking the equitable subordination provisions of § 510(c), nonetheless subordinate the creditor's claim to the claims of all other unsecured creditors.²⁹⁴ A claim for equitable subordination must be brought by an adversary proceeding and generally may be initiated only by a trustee or DIP unless a bankruptcy court authorizes another party to initiate such a proceeding.²⁹⁵

(internal citation omitted). But the court also noted that "if the conduct of the creditor is so egregious that it affects the validity of the claim under applicable principles of law, the debtor can seek to disallow it as part of the claims process." *Id.* at 237 n.4; *In re Werth*, 37 B.R. 979, 991 (Bankr. D. Colo. 1984) (noting that "the claim will be disallowed to the extent [the borrower] establishes damages under Colorado law, resulting from the Bank's breach [of an oral contract to lend money]").

292. See *O'Day*, 126 B.R. at 412 (noting situations where a three-part test for subordination is appropriate).

293. See *id.* at 411-12.

294. See *e.g., id.* at 412.

295. See *9281 Shore Rd. Owners Corp. v. Seminole Realty Corp. (In re 9281 Shore Road Owners Corp.)*, 187 B.R. 837, 852 (Bankr. E.D.N.Y. 1995) (holding that a claim for equitable subordination must be brought by trustee or DIP by commencing adversary proceeding in bankruptcy court); *In re Danbury Square Assocs.*, 153 B.R. 657, 661 (Bankr. S.D.N.Y. 1993) (stating that the claims must be brought by an adversary proceeding). An equitable subordination claim has been deemed, under some circumstances, to be a "core proceeding" under the Code, and may "trump" a pending state foreclosure action. In a Vermont bankruptcy case, *Merchants Bank v. C.R. Davidson Co., Inc. (In re CRD Sales & Leasing, Inc.)*, 231 B.R. 214, 218 (Bankr. D. Vt. 1999), the debtor-mortgagors brought an adversary proceeding against the mortgagee, and removed the mortgagee's pending state foreclosure action to the bankruptcy court. The debtors sought equitable subordination of the mortgagee's claim, injunctive relief, and a determination of the validity and extent of the mortgagee's lien. The equitable subordination claim was based on alleged misconduct by the mortgagee, including "breach of contract, tortious interference with a contract, promissory estoppel, violations of the Equal Credit Opportunity Act, violations of [a Vermont discrimination statute], and negligence." *Id.* at 217. Although foreclosure proceedings in state court are generally deemed "non-core," where the foreclosure action is based on the same facts as the debtor's equitable subordination claim, it may not be remanded to state court. The bankruptcy court held that if the automatic stay in bankruptcy were terminated and foreclosure proceeded, the trustee or DIP would be deprived of the equitable foreclosure defense, which is available solely as the result of federal bankruptcy law. *Id.* at 218-20. The court stated that, "[e]quitable subordination, for lack of a better term, is the

This aspect of creditors' rights risk involves some "inequitable" conduct of the lender-transferee unless the lender is a fiduciary or insider of the borrower, in which case a lower standard is applied.²⁹⁶ Because the lender is also the insured, a claim seeking to subordinate the lien of the insured mortgage pursuant to § 510(c) would most likely fall within Exclusion 3(a) of the Loan Policy as a matter "created, suffered, assumed or agreed to," and in most instances would involve action by the insured lender subsequent to the policy date within the scope of Exclusion 3(d). So even where the creditors' rights exclusion is deleted, the title insurer still may have a valid defense to a claim based on an allegation of equitable subordination of the insured's mortgage.²⁹⁷

An "equitable subordination" analysis is necessary only in loan transactions because it deals solely with circumstances where the priority of a security interest could be altered.²⁹⁸ It would be

proverbial 500-pound gorilla of this case – the doctrine is not bound by state law, and it can trump the state law foreclosure, even if that foreclosure is legally valid." *Id.* at 220. The court also stated that "[b]ecause the equitable subordination claim predominates this proceedings, [sic] we think that the entire matter is core under 28 U.S.C. §§ 157(B)(K) & (O). Accordingly, mandatory abstention does not apply." *Id.* See also *Poughkeepsie*, 132 B.R. at 292 ("If the automatic stay is terminated and the movant allowed to foreclose, the estate would be deprived of these defenses [equitable subordination] in the non-bankruptcy forum."); *Walker v. Bryans (In re Walker)*, 224 B.R. 239, 242 (Bankr. M.D. Ga. 1998) (stating that as an example, the Court "might decide that the conduct of Defendant in the foreclosure warrants equitable subordination of Defendant's claim while, at the same time, a state court might rule that foreclosure was proper and that no damages are warranted"); *Aetna v. Danbury Square Assocs. (In re Danbury Square Assocs.)*, 150 B.R. 544, 547 (Bankr. S.D.N.Y. 1993) (noting that remanding the pending foreclosure action to state court would deprive the trustee of the defense of equitable subordination); *9281 Shore Rd.*, 187 B.R. at 853 (stating that "[t]he basis for these rules of equitable subordination is that the bankruptcy court has the equitable power and the duty 'to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate.'" (citation omitted).

296. See *Estes v. N & D Props., Inc. (In re N & D Props., Inc.)*, 799 F.2d 726, 731 (11th Cir. 1986) (holding that lower standard applies when the lender is fiduciary to borrower).

297. The bankruptcy trustee generally must prove the lender engaged in specific "bad acts" or inequitable conduct in order to establish a claim for equitable subordination. These acts usually occur after the loan transaction has closed and the mortgage has been recorded. Therefore, it is the authors' opinion that no coverage is provided for such a claim under the 1992 ALTA Loan Policy. This is because Exclusions 3(a) and (d) respectively exclude adverse matters "created, suffered, assumed or agreed to," and matters "attaching or created subsequent to Date of Policy." The ALTA Forms Committee currently is preparing a new form of ALTA Loan Policy that does not contain a specific exclusion for equitable subordination, because the Committee believes that this specific exclusion is unnecessary and inappropriate in light of the foregoing policy exclusions.

298. See generally *Fabricators*, 926 F.2d at 1469 ("The ability to

rare for a title insurer to be able to identify an equitable subordination issue because, in most cases, the circumstances giving rise to the application of the doctrine will have taken place post-policy.²⁹⁹

If the lender has had a relationship with the borrower before the date the new loan is closed, such as when the new loan refinances an existing loan from the same lender, this will increase the risk that circumstances may exist that could result in an equitable subordination claim.³⁰⁰ This is particularly true if the lender to be insured is in a fiduciary relationship with the borrower or is deemed to be an "insider."³⁰¹

IV. UNDERWRITING CREDITORS' RIGHTS RISK

Title insurance underwriting generally involves identifying a legal basis for concluding that a particular risk to be insured against will not result in ultimate loss to the insured.³⁰² The same approach is necessary in underwriting creditors' rights risk.³⁰³ The goal is to find a legal basis for concluding that the transfer being insured cannot successfully be attacked as fraudulent or preferential to creditors of the transferor.

Where a creditors' rights issue has been identified because a transfer is being made without the transferor receiving reasonably equivalent value, the primary basis for underwriting the risk involves engaging in credit and finance underwriting.³⁰⁴ This is a significantly different approach to underwriting than what most underwriters are accustomed to, or prepared for, because it focuses on issues other than real estate.³⁰⁵

The following discussion assumes a transaction where a creditors' rights issue has arisen because one or more transfers have been, or will be, made in which the transferor does not receive "reasonably equivalent value."

recharacterize a purported loan emanates from the bankruptcy court's power to ignore the form of a transaction and give effect to its substance.") (citation omitted).

299. *Id.* See also the discussion at *supra* note 297.

300. *Id.*

301. *Id.* at 1465. See generally *In re Epic Capital Corp.*, 290 B.R. at 524 ("The burden of proof is less demanding when the respondent is an insider."); *In re Mid-Town Produce, Inc.*, 599 F.2d 389, 392 (10th Cir. 1979) ("Because there is incentive and opportunity to take advantage, dominant shareholders and other insiders' loans in a bankruptcy situation are subject to special scrutiny.").

302. See generally *Citizens & Southern*, 821 F. Supp at 1495-96.

303. *Id.*

304. See John L. Hosack & John C. Murray, *Maximizing the Benefits of Title Insurance*, Presentation to the American Bar Association, Spring 1996 Title Insurance Claims Seminar, May 31, 1996.

305. *Id.*

A. *"Fundamental" Nature of the Transaction*

It is important, in determining whether to delete the creditors' rights exclusion, to understand whether the transaction is (1) fundamentally a going-concern business transaction, incidentally involving real estate, or (2) fundamentally a real estate transaction, in which real estate is essentially the only business. A title insurer's ability to competently underwrite creditors' rights risk is far more limited in the former situation than in the latter. Title insurers are, therefore, more willing to undertake this type of underwriting in the context of transactions that are fundamentally real estate, and not business, in nature.

If the transaction is fundamentally a real estate transaction, it is easier for the title insurer to "get its arms around" the financial aspects of the transaction. To do so when the business is primarily real estate is really to understand the financial aspects of owning, operating and financing real property. On the other hand, if the transaction is fundamentally a "going concern" commercial business transaction, the likelihood that significant and unpredictable events can have a drastic and negative impact on the financial stability of the business is much greater.

B. *Type of Property Involved*

Income-producing commercial investment properties, such as office buildings, industrial buildings, shopping centers, and apartment projects (as opposed to labor- and management-intensive businesses such as hotels and manufacturing operations) are easier for title insurers to understand and analyze when performing a credit-underwriting analysis. The most favorable scenario involves a "seasoned" property with high occupancy rates and long-term leases to a variety of creditworthy tenants.

The owner's role in connection with these types of properties generally is a passive one. The ownership entity generates revenues from property rents and incurs the following expenses: ad valorem property taxes, utilities, insurance, management, maintenance and upkeep of the buildings, and debt service on any secured or unsecured financing. Most leases on these types of properties (particularly office buildings, industrial buildings, and shopping centers) make the rent "triple net" to the owner-landlord. As a result, most of the expense of owning and operating the real property is passed through to the tenant(s) and reimbursed to the landlord. The income statements for ownership entities whose assets consist of these types of properties commonly will have a line item under the "revenues" section of their income statements for "tenant reimbursements." This item offsets a portion of the itemized expenses and, by subtracting this line item from the total expenses, the title underwriter can determine what the owner's "net" expenses are for a given period of time.

In general, both the revenues and expenses with respect to income-producing real property involving credit tenants are predictable, quantifiable, and stable. It is, therefore, more likely that historical financial information will provide a fairly accurate basis for projecting probable future financial results in assessing whether the ownership entity is: (a) solvent at the time of the transfer and will remain solvent after the transfer, (b) engaging in a business or transaction that will leave it with unreasonably small capital, or (c) is about to incur debts beyond its ability to pay as they become due (being the three alternative tests for a constructively fraudulent transfer as discussed earlier in this Article).

Hotel properties generally are more problematic for a title insurer in performing a credit-underwriting analysis, because owning and operating a hotel is fundamentally an ongoing business (as opposed to a passive real estate investment). The revenue from hotel properties can be less stable or predictable than the revenue from office buildings, shopping centers, or industrial and apartment properties because changes in the general economy will have a more immediate and dramatic impact on revenue. In difficult economic times, one of the first reactions of the consuming and business public is to restrict or eliminate discretionary expenses such as travel. This can cause a positive and healthy cash flow situation rapidly to change to a negative and unhealthy one. But this scenario assumes that the owner of the real estate is also the owner of the hotel business. It is possible that the structure of hotel real estate may be similar to that involved in an office building, shopping center, industrial, or apartment property, with the ownership entity being a passive investor and the hotel business being operated by an unrelated entity. The unrelated entity usually manages or leases the hotel property under a long-term management agreement or lease and pays the debt service and operating expenses of the property from the hotel-room and related revenue. Such a structure could be evaluated in the same manner as other types of traditional real estate investment property. But because of the presence of a single "tenant" such as the hotel manager or lessee, that entity's creditworthiness and "track record" become critical independent factors in evaluating the likelihood of continual uninterrupted rental revenue.

C. Structural Features of the Transaction

To perform the required analysis, the title underwriter will want to obtain answers to the following questions:

- Who is the borrower and what is the borrower's legal structure? Is the borrower/mortgagor a "bankruptcy remote" SPE?

- Does the borrower have personal liability for the debt, or is the loan non-recourse? Is the loan guaranteed by any person or entity? If so, what is the guarantor's relationship to the borrowing entity?
- What type of property or collateral will secure the loan? Is this a "passive" real estate loan or a "going concern" business loan?
- What type of obligation(s) will the mortgage secure? If the mortgage secures a guaranty, does the guaranty contain any limitation on the amount that can be collected under the guaranty (such as a "net worth" limitation)?
- Does the mortgage contain release provisions allowing the mortgagor to obtain a release of the mortgage upon payment of an amount that is less than the full balance of the loan being guaranteed? If so, what is the formula and how does the calculated "release price" compare to the overall value of the subject real estate or the net worth of the borrower?
- What is the loan-to-value ratio? Has the real estate value been determined by an appraisal performed by a professional appraiser familiar with properties of that type in the relevant geographical area? If so, is the appraisal current? Was it prepared specifically for the subject transaction?
- What is the debt-service-coverage ratio, both currently (as of loan origination) and as projected for each year during the term of the loan?
- What is the term of the loan? Are there any rights to extend the maturity date? If so, what are the conditions imposed on the borrower's right to extend?
- Is the mortgage cross-collateralized to other mortgages executed by other borrowers? If so, is there a contribution agreement among the various borrowing entities that affords each entity a contractual right of contribution against all the other entities for any amounts paid on the aggregate loan amount in excess of the contributing entity's proportionate share?
- To whom are the loan proceeds being distributed and how will the disbursement affect the borrower's cash flow?
- Will the parent in an upstream or cross-stream transaction indemnify the title insurer against any claim by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws?

- Is there a requirement for a “lockbox” (or “cash management account” or “cash management agreement”) under the lender’s control into which all revenue from the income-producing real estate must be deposited, and out of which the lender’s debt service and other operating expenses (e.g., property taxes, insurance premiums, utilities, management, and maintenance expenses) must be paid before the borrower is entitled to any “net” (i.e., positive) cash flow?
- Are existing lines of credit available, and if so, what are their terms and how will they be affected by the proposed transaction?

The underwriter should closely analyze this structural information.³⁰⁶ If the borrower is personally liable for the loan, the borrower has a greater incentive to pay than if the loan is non-recourse.³⁰⁷ If the loan is guaranteed by the owner or owners of the borrowing entity, it is less likely that the owner or owners will cause the borrower to file a bankruptcy proceeding or fail to strenuously defend an involuntary proceeding filed against the borrower, because to do so would subject the owner or owners to personal liability under the guaranty.

If any guaranty is secured by the insured mortgage, and the guaranty contains “net worth” limitations, it is less likely that the mortgage will be challenged as a fraudulent transfer because, pursuant to such limitations, there can never be an amount owed under the guaranty that would render the guarantor insolvent, leave the guarantor with insufficient capital, or cause the guarantor to be unable to pay his, her, or its debts as they become due.

If the mortgage contains release provisions permitting the borrower to obtain a release of portions of the real estate collateral by paying a specified release price, which is based on its proportionate share of the obligation secured by the mortgage (plus, customarily, a premium), it is also less likely that the mortgage will be challenged as a fraudulent transfer. In this scenario, the release price can operate as a form of net worth limitation, depending on the particular formula utilized.

The lower the loan-to-value ratio, the less the likelihood of a

306. See *In re Knight*, 211 B.R. 747, 749 (Bankr. D. Or. 1997); *In re Roth*, 56 Bankr. 876, 877 (Bankr. N.D. Ill. 1986). See also Daniel G. Bogart, *Games Lawyers Play: Waivers of the Automatic Stay in Bankruptcy and the Single Asset Loan Workout*, 43 UCLA L. REV. 1117, 1219 (1996); Richard Kelly, *Foreclosure by Contract: Deeds in Lieu of Foreclosure*, 56 UMKC L. REV. 633, 638 (1988); Gene A. Marsh, *Lender Liability for Consumer Fund Practices and Home Improvement Contractors*, 45 ALA. L. REV. 1, 10 (1993).

307. See Bogart, *supra* note 306, at 1225.

fraudulent transfer claim because, at least with SPE borrowers, the subject property will be the only asset and the subject loan the only long-term liability. On a balance-sheet basis, the borrower will be solvent so long as the value of the subject real estate exceeds the outstanding loan balance. The question then becomes whether the borrower has an income stream sufficient both to service the long-term debt represented by the loan and to pay unsecured creditors.³⁰⁸

The term of the loan is also very important as it relates to the statute of limitations for fraudulent transfer challenges. If the loan term is seven years or more, then generally the focus is on whether the borrower has sufficient revenue to service the debt and pay unsecured creditors for that length of time. Even where the borrower has sufficient revenue to service its debts on an annual basis, when a "balloon" loan (i.e., an interest-only loan or a loan that does not fully amortize during its term) matures, the borrower must be able to pay the outstanding loan balance in full. Many borrowers rely on their ability to refinance the loan at maturity with the existing lender or a new lender, or to generate sufficient revenue from a subsequent sale of the property. However, if the borrower is unable to sell or refinance the loan when it matures, there is a very strong motivation to file a bankruptcy proceeding because the borrower can then utilize the "cram down" provisions of the Code to force the lender to accept an extended maturity date.³⁰⁹

If the loan matures by its terms within the statute of limitations for a fraudulent transfer challenge, rather than after the statute of limitations expires, there is a higher risk of a fraudulent transfer challenge to the insured mortgage if a bankruptcy proceeding is filed by or against the borrower. Even when the borrower's financial position is favorable at the time of loan origination, future economic factors that are impossible to accurately predict can have a negative impact on the borrower's ability to pay the loan at maturity. Thus, the creditors' rights analysis becomes more challenging and risky with loans having maturity dates between one and seven years from the date of the loan and, hence, within the statute of limitations for a fraudulent transfer challenge under the Code or state law.

As previously discussed, a contribution agreement among the various entities that are pledging their assets as security for a cross-collateralized loan can be helpful to the financial analysis of the transaction. The problem with cross-collateralization is that a

308. For example, a debt-service-coverage ratio of at least 1:2 usually indicates that the borrowing entity has sufficient revenue to pay its debts as they become due (including debt service on the subject loan).

309. See Murray, *The Lender's Guide*, *supra* note 141, at 471 n.186 (comparing risks and benefits of a "cramdown" for unsecured creditors).

mortgage securing obligations of entities other than the mortgagor can, without other structural features, create per se insolvency because the mortgagor's liabilities will always exceed its assets. If the borrower has the right to seek contribution from the other SPE entities, whose debts it has in effect guaranteed with its mortgage, the value of the contribution rights—discounted by the probability that the rights can be collected upon—can be treated as an asset on its balance sheet.

The benefit of indemnification from the parent entity or other party benefited by the mortgage transaction being insured (assuming there is real financial strength behind the indemnity) is that it affords the title insurer a direct contract right of action against the indemnitor, without the necessity for the insurer to first pay and then seek recovery through its subrogation rights. If a common parent entity is transferring real estate to a number of SPEs that it will own and control, and those entities will then borrow funds that are "upstreamed" for the benefit of the parent, the parent's indemnification of the title insurer works similarly to a parent guaranty of the indebtedness (i.e., its existence makes it less likely that the parent will cause any one of the SPEs to file a voluntary bankruptcy proceeding, which would trigger the title insurer's right to recover under the indemnity agreement). Thus, the parent will be forced to pay the debt itself or file its own bankruptcy proceeding. Where the parent has guaranteed the loan, indemnification of the title insurer does not result in the parent incurring any greater obligation than it already has under the guaranty. The title insurer can, through its subrogation rights, still maintain an action against the parent under the parent's guaranty, but a direct contract right of action is always preferable.

The "lockbox" or "cash management account" structural features of the loan also should be scrutinized. The key question in analyzing a transaction involving cross-collateralization, as well as "upstream," "downstream," and "cross-stream" guarantees is: How will the debt be paid? Transactions structured in this manner frequently result in per se insolvency when viewed from the perspective of an entity that is obligating itself to pay not only its own debt, but also the debts of a number of other related entities. No single borrowing entity has the revenue sufficient to pay the debt service on the "global" loan, much less the ability to pay off the loan when it matures. For that reason, there needs to be a mechanism for making certain that the global debt will be serviced and that the unsecured creditors of all of the mortgaging entities will be paid. That mechanism is the lockbox controlled solely by the lender, into which all the revenue generated by each mortgaging entity is deposited monthly. This provides a fund (or "waterfall") that is sufficient to pay the aggregate debt service and

each entity's unsecured creditors. This feature is beneficial to fraudulent transfer analysis, particularly when the loan matures beyond the applicable statute of limitations, because it assures that secured and unsecured creditors will be paid as long as sufficient revenue is generated from the property.

D. Financial Information

The title underwriter may need to obtain and review the financial statements for the transferor(s)/mortgagor(s), including balance sheets, income statements, and cash flow reconciliations. These documents should contain current information and historical information for at least the prior three—and preferably five—years. The current period should include the most recent full calendar year and the current year-to-date through the most recent full quarter. The goal of this current-period and historical information is to obtain a summary of the “year-over-year” financial and operating experience of the borrowing entity. “Pro-forma” financial statements also should be obtained to project the expected post-transaction results. These financial statements should be certified as accurate and complete by a certified public accountant—or at least by the chief financial officer of the borrowing entity. In addition, with the wealth of information currently available on the Internet, it has become easier and less expensive to access both positive and negative information about a publicly traded company that is entering into a real estate transaction. It also can be enlightening and informative to review newspaper articles, press releases, and reports by credit rating agencies, as well as annual reports and other items filed with the Securities and Exchange Commission. These sources can reveal much about a company that is about to transfer title to its real estate or obtain a mortgage loan.

Balance sheets (including footnotes that itemize contingent liabilities) reflect the “assets,” “liabilities,” and “net worth” (or “owner’s equity”) of the transferor(s)/mortgagor(s) and will assist the underwriter in determining whether the entity is solvent at the time of—and likely to remain solvent after—the subject transaction. Income statements, sometimes called “profit and loss” (or “P&L”) statements, reflect the transferor(s)/mortgagor(s) revenues, expenses, and net profit (or net loss) and will assist the underwriter in determining whether the transferor entity is entering into a transaction that will leave it with insufficient capital or cause it to incur debts beyond its ability to pay them as they become due. The cash flow reconciliations reflect the true cash flow of a transferor/mortgagor entity by reconciling a number of non-cash expense items (such as depreciation) to show the net change in the cash position from one period to the next. These statements are helpful in assessing the entity’s ability to pay its

debts as they become due, and in determining whether the entity will be left with sufficient capital to fund its operations after the subject transaction has closed.

With income-producing real estate, annual total unsecured debts and "trade payables" are important factors that can be addressed by reviewing the income statements. The annual unsecured expenses should be analyzed both with and without the offset of reimbursements from tenants because reimbursements from tenants can be delayed or suspended if an unanticipated event precipitates significant tenant defaults.

V. REINSURANCE ISSUES

The ceding company (i.e., the primary insurer) in a title reinsurance transaction owes a duty of "utmost good faith" to the reinsurers to whom it is offering reinsurance.³¹⁰ Accordingly, if there are creditors' rights issues in a transaction where a title insurer or the insured expects to require reinsurance, these issues must be clearly identified and disclosed to the reinsurers. The ceding insurer must provide a thorough explanation to the reinsurers of the underwriting basis upon which it made its determination that it could safely issue the policy without a creditors' rights exclusion.

If a creditors' rights issue is present, but the ceding insurers cannot convince the reinsurers that there is no appreciable risk of a fraudulent- or preferential-transfer challenge to the insured transaction, then it is likely that the title insurance policy to be issued in connection with the transaction will necessarily contain the creditors' rights exclusion as a condition to the reinsurers' acceptance of the ceding company's offer of reinsurance. This may cause a delay in the closing of the transaction in cases where the insured is requiring evidence of reinsurance as a condition to closing. The title insurer also may be unable to obtain reinsurance on its own after closing, in cases where the amount of insurance is in excess of the insurer's self-imposed retention limits or the insurer simply desires to spread the risk at lower dollar levels.

The need for reinsurance is another reason why it is critical to identify creditors' rights issues and commence the underwriting of

310. See *ReliaStar Life Ins. Co. v. IOA Re, Inc.*, 303 F.3d 874, 877-78 (8th Cir. 2002) ("Reinsurance relationships are governed by the traditional principle of 'utmost good faith.' The duty of good faith is essential to the industry, inasmuch as 'reinsurers depend on ceding insurers to provide information concerning potential liability on the underlying policies.' Reinsurers must rely on this principle because they generally do not duplicate the functions of the ceding insurers, such as evaluating risks and processing claims. To arrange their business otherwise would result in greatly increased costs for both reinsurance and the underlying policies themselves.") (internal citations omitted).

those issues as early as possible. This urgency stems from the time and effort it can take to obtain reinsurance, particularly when the policy will be issued without a creditor's rights exclusion and the ceding company cannot competently represent that there are no creditors' rights issues in the transaction.³¹¹

No one appreciates having a closing "hang in the balance" while the reinsurance representatives of a ceding company work with their counterparts at other companies who are being offered reinsurance to obtain acceptance of the offer of reinsurance. Historically, reinsurance has tended to be a last-minute item on a closer's checklist.³¹² Where the customer is requiring a policy without a creditors' rights exclusion, and creditors' rights issues are present in the transaction, reinsurance should be moved to the "top of the list" if the customer and the ceding company wish to avoid the pain and embarrassment of "eleventh hour" reinsurance negotiations and the risk that reinsurance cannot be obtained.³¹³

VI. CONCLUSION

Obtaining title insurance coverage against the risk of fraudulent or preferential transfer challenges to the underlying title or to the lien of an insured mortgage has proven to be a very important goal for the title insurance industry's customers. Fortunately, a significant percentage of the real estate transactions handled by title insurers contain no creditors' rights issues of the kind addressed by the creditors' rights exclusion. The industry has, therefore, been able to safely delete the exclusion in most cases and, more recently, issue endorsements expressly insuring against this risk (where available and appropriate).

There always will be some transactions in which creditors' rights issues are clearly present. In some of these transactions title insurers may feel competent to underwrite the risk. In others, insurers simply will not be able or willing to underwrite the risk and, as a result, will refuse to issue the title insurance policy without the creditors' rights exclusion.³¹⁴ LBOs and other types of leveraged corporate transactions involving going-concern businesses are likely examples of the latter transactions.³¹⁵

311. See John C. Murray, *Title Insurance - The Commercial Lender's Perspective*, available at <http://www.firstam.com/faf/tml/cust/jm-commercial.html> (last visited Feb. 15, 2005).

312. *Id.*

313. *Id.*

314. See Murray, *Creditors' Rights*, *supra* note 1 (explaining that insurers may not be comfortable issuing certain policies because legal costs of defending actions arising from some transactions are prohibitive, even if action is ultimately successful).

315. See *id.* (noting that insuring these types of transactions requires high level of due diligence on the part of title insurance company).

As highlighted in this Article, creditors' rights issues arise in a variety of contexts and there is no simple solution that applies to every fact situation. It is important for the title insurer and its customers to carefully perform their respective due diligence, and to identify and evaluate the risks involved in a particular transaction, at the earliest possible stages. The parties must balance the lender's desire to protect its rights in the real property collateral, and its remedies with respect to repayment of the mortgage indebtedness, with the title insurer's legitimate need to minimize the risk of potential challenges based on the violation of federal and state bankruptcy and insolvency statutes. By working closely with each other and sharing relevant information at the earliest stages of the transaction, lenders and title insurers often can effect creative solutions to creditors' rights issues, and obtain title insurance coverage for lenders, in appropriate circumstances, that provide beneficial protection for their interests.³¹⁶

Title insurers do not and cannot view the creditors' rights risk as one of "blind risk assumption."³¹⁷ The legal costs of defending an action based on a creditors' rights claim can be substantial, even if the title insurer ultimately prevails on the merits. If a creditors' rights issue is present in a transaction, and there is an expectation that the title insurance policy will not contain the creditors' rights exclusion, the title insurer will require, and will need sufficient time to review and analyze, a substantial amount of pertinent information about the nature and structure of the transaction and the financial position of the transferring parties.³¹⁸

As described in note 2, *supra*, title insurance companies can now offer—subject to standard underwriter criteria and where not otherwise prohibited by state statutes or regulations—an affirmative ALTA-approved endorsement for specific creditors' rights issues. This coverage is issued on a case-by-case basis and is tailored to cover only certain risks.

316. *Id.*

317. *See id.* (noting that the title insurer should provide insurance only for specific risks that it feels comfortable assuming).

318. *See id.* (explaining complicated nature of the underwriter's task in these situations).