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FRAUDULENT CONVEYANCE BASICS AND AVOIDING POST-CLOSING LITIGATION CHALLENGES TO AN ASSET SALE

California's Uniform Fraudulent Transfers Act ("UFTA") has long set forth the legal components necessary to establish a claim for actual and constructive fraudulent conveyances. A significant aspect of the UFTA is its remedy of enabling creditors to void a debtor's transfers if certain elements are met. In the M&A context, several fundamental questions can arise in connection with a transfer that an outside creditor or other third party seeks to establish as actually or constructively fraudulent. First, under what circumstances will a court re-characterize debt into equity? Second, how do courts determine a company's insolvency and interpret "reasonably equivalent value" under the constructive fraud provision? Third, how do courts apply the so-called "badges of fraud" under the actual fraud provision? These hot-button legal issues have carried particular importance and stymied several courts in their review of asset purchase arrangements. Many courts have struggled to identify a clear set of legal criteria for determining whether the sale or a portion of the sale should be voided and the funds restored to the purchaser under the UFTA.

The legal elements of California's fraudulent conveyance causes of action are codified under the UFTA at Cal. Civ. Code §§ 3439.04(a)(1) and 3439.08 (actual fraud) and Cal. Civ. Code §§ 3439.04(a)(2) and 3439.05 (constructive fraud). With regard to the first type of claim, a creditor can void as "actual fraud" any transfer made or obligation incurred by a debtor if the debtor acted with ***"[w]ith actual intent to hinder, delay, or defraud any creditor of the debtor."*** Cal. Civ. Code § 3439.04(a)(1) (emphasis supplied). In California, not unlike many other jurisdictions, eleven factors or "badges of fraud," are used to determine actual fraud, prompting courts to consider whether the transfer should be voided:

(1) The transfer or obligation was to an insider,
(2) The debtor retained possession or control of the property transferred after the transfer,
(3) The transfer or obligation was disclosed or concealed,
(4) Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit,
(5) The transfer was of substantially all the debtor's assets,
(6) The debtor absconded,
(7) The debtor removed or concealed assets,
(8) The value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred,
(9) The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred,*
(10) The transfer occurred shortly before or shortly after a substantial debt was incurred, and
(11) The debtor transferred the essential assets of the business to a lienholder who transferred the assets to an insider of the debtor. Cal. Civ. Code § 3439.04(a)(1).

With regard to the second type of claim, a creditor can void as "constructive fraud" any transfer made or obligation incurred by a debtor if the debtor made the transfer ***"[w]ithout receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor either: (A) [w]as engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction[, or] (B) [i]ntended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due."*** Cal. Civ. Code § 3439.04(a)(2) (emphasis supplied).

Courts have interpreted the above statutory elements to analyze and decide at least three "hot button" legal challenges of late in the M&A litigation context.

<u>Hot-Button Legal Challenge No. 1.</u> Voiding Transfers by Applying "The Badges of Fraud" and "Reasonably Equivalent Value. Three recent cases provide insight on how courts are applying the various "badges of fraud" under the UFTA's actual fraud provision. While the first two cases strictly applied the badges of fraud, the third case applied equitable considerations. First, *In re Tag Entm't. Corp.*, 2016 WL 1239519, at *1 (Bankr. C.D. Cal. Mar. 29, 2016), analyzed whether actual fraud occurred. In that case, a California bankruptcy court held creditor did not show that debtor intended to "hinder, delay, or defraud any creditor" where six of the "badges of fraud" weighed in debtor's favor. *i.e.,* the debtor's transfer was not to an insider, did not result in the debtor retaining possession or control of the funds after the transfer, was not concealed, did not involve the debtor absconding, and did not involve the debtor removing or concealing assets. *Id.* at *24. Creditor also failed to show debtor was insolvent. *Id.* The result in that case was the creditor could not void transfer based on actual fraud claim. *Id.*

A similar result was reached in *In re Empire Land*, LLC, 2016 WL 1391297, at *1 (Bankr. C.D. Cal. Apr. 4, 2016), where a California bankruptcy court denied defendant's motion for summary judgment and held creditor had sufficient evidence of "badges." *Id.* at *8—9. Creditor was a trustee who sought to avoid multiple transfers between the debtors and a California corporation that was "either the general partner or managing member" for the debtors. *Id.* at *1—2. Defendant-company described the transfers as "short term inter-company loans." *Id.* at *1—3. After finding that the second and fourth badges of fraud weighed in defendant's favor *i.e.*, debtor did not retain possession or control of the funds and no actual or threatened litigation against the debtor existed, the *Empire* court denied summary judgment because **three** badges of fraud weighed in the creditor's favor, namely, the first, ninth, and tenth badges of fraud (special relationship existed between the debtor and the defendant since the defendant was the debtor's general partner, debtor was insolvent at the time of the transfers, and the transfers occurred shortly before the debtor incurred substantial debt).

However, *In re Martirosian*, 2017 WL 1041107, at *1 (Bankr. C.D. Cal. Mar. 14, 2017) was decided using a different set of criteria. In that case, a California bankruptcy court held party could succeed on its actual fraudulent transfer claim even when no badges of fraud weighed in its favor, ruling "[t]he eleven factors listed in the UFTA as probative of intent—the so-called "badges of fraud"—are not exclusive. 'A trier of fact is entitled to find actual intent based on the evidence in the case, even if no 'badges of fraud' are present. Conversely, specific evidence may negate an inference of fraud notwithstanding the presence of a number of badges of fraud.'" *Id.* at *11 (quoting *In re Beverly,* 374 B.R. 221, 236 (B.A.P. 9th Cir. 2007)). In *Martirosian*, the debtor approached the plaintiff and said he was a real estate broker that could sell him property for $350,000.00. *Id.* at *2. The plaintiff paid the debtor but never received the property because the debtor sold it to his wife to keep it out of the reach of his creditors. *Id.* at *3. The plaintiff sought injunctive relief to keep the defendants, which included the debtor, his wife, and real estate investment companies, from foreclosing on or facilitating the transfer of real property. *Id.* at *1. The court granted injunctive relief, in part, because it found that the plaintiff was likely to succeed on his fraudulent transfer claim. *Id.* at *11.[1]

Turning to the related concept of what constitutes "reasonably equivalent value" under the UFTA's constructive fraud provision, two recent cases provide insight on how courts are defining this historically amorphous legal standard.[2]

In re Castle Trading, Inc., 2017 WL 2375493, at *1 (B.A.P. 9th Cir. May 31, 2017) was decided by a Ninth Circuit bankruptcy court that looked to other provisions and found that "[t]he Bankruptcy Code defines 'value' as 'property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor[.]' State law is similar." *Id.* at *5 (citing § 548(d)(2)(A) and Cal. Civ. Code § 3439.03). Further, "[t]he Ninth Circuit has not explicitly stated whether an executor contract or promise of future services can qualify as 'value.' However… '[c]ase law has embroidered this concept to include 'any benefit' to the debtor, 'direct or indirect' as value.'" *Id.* (citing *In re Pringle*, 495 B.R. 447, 463 (9th Cir. BAP 2013). Next, the *Castle* court specified that reasonably equivalent value "'is not an esoteric concept: a party receives reasonably equivalent value…**if it gets roughly the value it gave**.'…[C]ourts assess reasonably equivalent value from the creditors' perspective…and 'the focus is whether the net effect of the transaction has depleted the bankruptcy estate…[T]he concept of 'reasonably equivalent value' does not demand a precise dollar-for-dollar exchange.'" *Id.* at *6—7 (quoting *In re Pringle*, 495 B.R. at 463—64) (emphasis added). In *Castle*, a creditor appealed a lower court's finding that it could not void the debtor's transfer of a promissory note to a law firm as purported payment for legal services. *Id.* at *1. After it considered several facts, the court in *Castle* rejected the creditor's argument that the debtor did not receive reasonably equivalent value for this transfer. *Id.* at *6—7. First, the court upheld the lower court's decision to consider the future value of the legal services because that lower court weighed the evidence and made a factual determination based on credible testimony. *Id.* at *7. Likewise, the court upheld the lower court's decision not to cap the amount reflected in the firm's billing records and reasoned that an exact dollar amount could not be associated with the firm's actual legal services since it was not billing by the hour. *Id.*

Not unlike *Castle, Alabado v. French Concepts, Inc.*, 2016 WL 5929247, at *1 (C.D. Cal. May 2, 2016), involved a finding by the California federal district court that creditors, who were trustees, alleged sufficient facts to survive debtor's motion to dismiss claims that the

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[1] The *Martirosian* court opined that while evidence of the fraudulent transfer was circumstantial, it "overwhelmingly" indicated that debtor transferred the property to his wife with the intent to hinder, delay, and defraud the debtor's creditors, specifically finding that the debtor (1) filed for bankruptcy falsely claiming that the property still belonged to him, and (2) used the bankruptcy case to strip off judgments against the property. *Id.* Moreover, debtor's wife gave the property to another party, which the court held "[was] not an arm's length purchaser and [worked] in collusion with the [d]ebtor and his wife." *Id.* The court thus held "[i]njunctive relief is appropriate in this circumstance to preserve the status quo pending final adjudication of that claim." *Id.* at *12.

[2] Under constructive fraud, a creditor can void a transfer made or obligation incurred by a debtor if the debtor made the transfer "[w]ithout receiving a reasonably equivalent value in exchange for the transfer or obligation." Cal. Civ. Code § 3439.04(a)(2).

debtor fraudulently transferred property to her husband to place it out of reach of the creditors. *Id.* at *11. Creditors alleged the transfer was actually and constructively fraudulent, based on evidence that "[the debtor] received no compensation for [the] transfer, thus it was for far less than reasonably equivalent value." *Id.* The court held that "[e]ven if the facts [were] insufficient to show actual intent, [the creditors] sufficiently alleged constructive fraudulent transfer, because the transfer was made without receipt of reasonably equivalent value in return." *Id.* at *20.

<u>Hot-Button Legal Challenge No. 2.</u> Re-characterizing Debt As Equity. At the outset, it is somewhat an open question when the so-called "re-characterization" remedy is triggered. In California, for example, courts have been unclear on whether re-characterization applies to an actual or constructive fraud claim. For example, *In re Fitness Holdings Intern., Inc.*, 714 F.3d 1141, 1147 (9th Cir. 2013), analyzes re-characterization as a feature and potential remedy for constructive fraud, while *In re UC Lofts on 4th, LLC*, 2014 WL 1285415, at *23 (Bankr. S.D. Cal. Mar. 27, 2014) goes further and analyzes re-characterization as a separate, standalone claim. Several other courts have likewise recognized re-characterization as a stand-alone claim. *See, e.g.*, *Screen Capital Intern. Corp. v. Library Asset Acquisition Co., Ltd.*, 510 B.R. 248, 262 (C.D. Cal. 2014); *In re LMI Legacy Holdings, Inc.*, 2017 WL 1508606, at *14 (Bankr. D. Del. Apr. 27, 2017).

Another initial consideration is when will debt likely be re-characterized and what factors are to be considered by a court in deciding the issue. Here, it may come as no surprise to learn that courts have used a variety of approaches to determine whether a creditor's claim that debt should be re-characterized as equity has merit. The modern trend is that many courts now appear to rely on a factor approach (*e.g.,* Delaware) while others assess a parties' intent, the relationship between the debtor and defendants, and whether the defendants engaged in inequitable conduct. (*e.g.,* California).

Thus, utilizing a factor approach, a Delaware court in *LMI*, 2017 WL 1508606 analyzed whether re-characterization was appropriate where the defendants owned a 62.5% equity interest in the debtor, controlled the board, and held a claim against the debtor for $5,200,000.00 derived from three promissory notes. *Id.* at *2. Creditor was a trustee who sought to re-characterize those promissory notes into equity. *Id.* To analyze whether notes should be re-characterized as equity, the Delaware bankruptcy court borrowed the Sixth and Third Circuit's eleven-factor test[3][4] *Id.* at *14, as follows:

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[3] *In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 747—48 (6th Cir. 2001) (citing *Roth Steel Tube Co. v. C.I.R.*, 800 F.2d 625, 630 (6th Cir. 1986) (listing the following as factors to be used in determining re-characterization: "(1) the names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between the creditor and the stockholder; (7) the security, if any, for the advances; (8) the corporation's ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments.")).

[4] *In re SubMicron Systems Corp.*, 432 F.3d 448, 455 (citing *In re Color Tile, Inc.*, 2000 WL 152129 at *4 (D. Del. Feb. 9, 2000) (listing the following factors, "(1) the name given to the instrument; (2) the intent of the parties; (3) the presence or absence of a fixed maturity date; (4) the right to enforce payment of principal and interest; (5) the presence or absence of voting rights; (6) the status of the contribution in relation to regular

(a) [N]ames given to the instruments, if any, evidencing the indebtedness;
(b) Presence or absence of a fixed maturity date and a schedule of payments;
(c) No fixed rate of interest and interest payments;
(d) Whether repayment depended on success of the business;
(e) Inadequacy of capitalization;
(f) Identity of interests between creditor and stockholder;
(g) Security, if any, for the advances;
(h) Ability to obtain financing from outside lending institutions;
(i) The extent to which the advances were subordinated to the claim of outside creditors;
(j) The extent to which the advances were used to acquire capital assets;
(k) Presence or absence of a sinking fund; (l) Presence or absence of voting rights; and
(m) "Other considerations." *Id.*

Applying the eleven factors*, LMI* held that factors (e), (h), (i), and (j) favored re-characterizing the loans because creditor alleged that there was "[i]nadequate capitalization in connection with the…notes, [f]ailure to try to obtain capital elsewhere, [s]ubordination of the [n]otes to debt held by the [d]ebtors' lenders, and [u]se of the advances to acquire or pay the [d]ebtors' capital acquisitions." *Id.* Creditor thus alleged sufficient facts to avoid a motion to dismiss. *Id.*

California's approach differs from Delaware's and may be best described as an "intent" test. Thus, for example, in *UC Lofts*, creditor was a trustee who sought to re-characterize defendants' loans to the debtors as equity.[5] *UC Lofts*, 2014 WL 1285415 at *23. In determining whether to re-characterize the loans, that court considered the debtors' and defendants' intent, the relationship between the debtors and defendants, and whether the defendants engaged in inequitable conduct. *Id.* at *22—23. For example, the court in *UC Lofts* held, "court[s] will look to the parties' intent to determine their status as equity interest holder or creditor" and found that the relationship between the debtors and the defendants was strictly limited to that of a borrower and lender. *UC Lofts*, 2014 WL 1285415 at *23 (citing *Fitness Holdings*, 714 F.3d at 1148; *Sw. Concrete Prods. v. Gosh Constr. Corp .,* 51 Cal. 3d 701, 710 (1990); and *Hoppe v. Rittenhouse,* 279 F.2d 3, 8 (9th Cir.1960)). Additionally, none of the defendants were insiders or partners of the debtors and there was no evidence defendants engaged in inequitable conduct. *Id.* Creditor's re-characterization claim was dismissed.[6] *Id.*[7]

<u>Hot-Button Legal Challenge No. 3. </u> Voiding Transfers Based on Debtor's Insolvency. As with re-characterization, the initial consideration is when is an insolvency analysis triggered. In California, creditors can use the UFTA's constructive fraud section to void a debtor's transfer or obligation the debtor incurred by proving (1) there is a conveyance or creation of an obligation, (2) the debtor, at the time of the conveyance, was insolvent or the

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corporate contributors; and (7) certainty of payment in the event of the corporation's insolvency or liquidation.")).

[5] The Court held that creditor "presented only scant argument" on the re-characterization claim. *Id.* at *23.

[6] *See, id.* at *22—23 (refusing to recharacterize the claims "for many of the same reasons it denie[d] the [t]rustee's request to equitably subordinate [the] claims," which included the fact that "the court…found that none of the [d]efendants was an insider or partner of the [d]ebtors…[n]or [did] the evidence establish that the [defendants] engaged in inequitable conduct").

[7] In *Screen Capital*, a California appellate court reached the same result, but merely because the creditor failed to allege that the debtors were borrowers under the loans at issue. *Screen Capital*, 510 B.R. at 262.

transfer rendered him insolvent, and (3) the conveyance was made without a fair consideration. *Estate of Heigho*, 186 Cal. App. 2d 360, 365—66 (1960). A related, but equally important, consideration is the so-called "insolvency presumption" and determining when and under what circumstances the presumption is rebutted. Here, although Cal. Civ. Code § 3439.02 contains an insolvency presumption, it does not state which accounting methodology applies to determine insolvency. The Ninth Circuit bankruptcy court, in *In re Village Concepts, Inc.*, 2015 WL 8030974, at *1 (B.A.P. 9th Cir. Dec. 4, 2015), recently held, "there are two alternative tests to establish a debtor's insolvency—the balance sheet test and the cash flow test." *Id.* at *8. Under the cash flow test, a court considers whether a debtor is generally paying his or her debts as they become due. *Id.* at *7 (citing Civ. Code § 3439.02(c); *In re Bay Plastics*, 187 B.R. 187 B.R. 315, 328 (Bankr. C.D. Cal. 1995)).

Next, perhaps the most critical component of the "insolvency" analysis is to apply one or more accounting methodologies. A review of recent cases demonstrates a minority of courts appear to use the cash flow test. Two recent cases, *Village Concepts* and *UC Lofts*, analyzed insolvency using a cash flow methodology. Notably, the court in *Village Concepts* limited the liabilities it considered in a solvency calculation to those that were "definite" and "material," while the court in *UC Lofts* limited the assets it considered to those that were "accessible." *Village Concepts*, 2015 WL 8030974 at *10; *UC Lofts*, 2015 WL 8030974 at *16. Apart from these cases, however, the majority view appears to be that a balance sheet approach should be utilized. Accordingly, the below cases analyze insolvency and illustrate the meaning of "fair valuation" and when courts can consider contingent liabilities and assets in a "balance sheet" methodology.

Courts have initially looked at the threshold question of how "fair valuation" as set forth in the UFTA is determined. Cal. Civ. Code § 3439.02(a) states, "[a] debtor is insolvent if, at a *fair valuation*, the sum of the debtor's debts is greater than the sum of the debtor's assets." (emphasis added). Recent cases that specifically addressed "fair valuation" evaluated it exclusively under the balance sheet test, illustrated the difference between "fair valuation" and "generally accepted accounting principles," and reviewed the debtor's balance sheet opposed to other documents. For example, in *In re Walldesign, Inc.*, 2017 WL 1228399, at *1 (C.D. Cal. Mar. 31, 2017), a California federal court upheld a bankruptcy court's finding that a debtor was insolvent at the time of a conveyance under the balance sheet test. *Id.* at *5. Creditor/appellee was The Official Committee of Unsecured Creditors of the Estate of Walldesign, which sought to recover payments that debtor transferred to the appellants. The court rejected appellant's argument that the debtor was solvent at the time of the transfer and held that the creditor/appellee calculated solvency using the correct method, "fair value," while the appellant calculated solvency using "generally accepted accounting principles." *Id.* at *4. Moreover, the so-called "fair value" or balance sheet method "more fairly reflects the actual financial condition of the [d]ebtor after the transfer from a creditor's point of view" than the "generally accepted accounting principles" method, which includes assets that cannot be sold to satisfy a creditor's claim. *Id.* (citing *In re Richmond Produce Co., Inc.*, 151 B.R. 1012, 1019—1020 (Bankr. N.D. Cal. 1993). Accordingly, bankruptcy court did not err in holding debtor was insolvent. *Walldesign*, 2017 WL 1228399 at *5.

Likewise, in *In re Garoian*, 2014 WL 7802600, at *1 (Bankr. C.D. Cal. Oct. 7, 2014), creditor was the trustee of the bankruptcy estates of the consolidated debtors. *Id.* at *1. The court defined "fair valuation" as "evaluat[ing] the debtor's assets and liabilities based upon a practical assessment of their actual value…rather than in accordance with generally accepted accounting principles." *Id* (citing *Bay Plastics*, 187 B.R. at 330).[8] Once again, the court found that a ***balance sheet test*** must be used in reviewing debtor's bankruptcy schedules, finding debtors' $1,722,949.58 debt was greater than its $968,363.54 in assets and holding creditor established debtor was insolvent under § 3439.02. *Id.*

Similar to *Garoian*, the court in *In re Pac. Thomas Corp.*, 543 B.R. 627 (Bankr. N.D. Cal. 2015). Also applying a ***balance sheet test*** to find debtor was insolvent where its balance sheet indicated total asset value was less than the liabilities. *Id.* at 636. Creditor, who was trustee of the bankruptcy estate, brought an adversary proceeding to recover transfers that the debtor made to the defendant on the grounds debtor was insolvent under § 3439.02. *Id.* Defendant sought to establish that the debtor was not insolvent based on an email from debtor's agent to a lender which listed properties owned by the debtor as having an approximate value of $19 mm. *Id.* In contrast, the debtor's balance sheet indicated that its total assets were $14,563,204.00 and that its liabilities were $15,111,415.00. *Id.* The court found that the balance sheet provided better evidence of the debtor's asset value than the email and entered judgment for the creditor. *Id.*

The above holdings can be compared to another recent case in which a creditor failed to prove that a debtor was insolvent is *Village Concepts*. There, the Ninth Circuit bankruptcy court used the balance sheet test and opined that "fair valuation" under § 3439.02 differed from "generally accepted accounting principles" since the former calculates assets at "current market value," whereas the latter calculates them at "historic cost." *Id.* at *8 (citing *Bay Plastics*, 187 B.R. at 330). Creditor/appellant was a trustee who filed a complaint to avoid alleged fraudulent transfers made by the debtor to the appellees. *Id.* at *1. Creditor argued the balance sheet prepared by an appellee conclusively proved debtor was insolvent, but the court disagreed and found the balance sheet was not reliable since 1) the person who prepared the balance sheet was not a financial expert,2) that same person did not specify which method he used to calculate the 'fair' value, and 3) the creditor did not provide an expert to aid the court in determining the proper assumptions underlying the numbers. *Id.* at *8—9. Accordingly, the lower court correctly found creditor did not demonstrate debtor was insolvent. *Id.* at *10.

Another issue that arises depending on the type of accounting methodology being used is the extent to which a party's contingent liabilities can or should be considered. Two recent cases hold courts can consider contingent liabilities when calculating insolvency under constructive fraud. First, in *In re Ryder*, 2016 WL 5819796, at *1 (Bankr. N.D. Cal. Oct. 5, 2016), a California bankruptcy court included a liability in calculating a debtor's insolvency, even though the liability was contingent. In this case, the debtor transferred interest in her real property to her sister one day before she filed for bankruptcy. *Id* at *1. Creditor was the former husband of the debtor, and he argued that the transfer was voidable as a constructive fraudulent transfer. *Id.* The court found that the only real issue was solvency and held, "[a] bankruptcy court is free to consider subsequent events in valuing and adjusting assets and determining liabilities for insolvency determinations." *Id.* at *1 (citing *In re Weinberg,* 410 B.R. 19, 33 (B.A.P. 9th Cir. 2009). The court then found that the marital dissolution decree between the debtor and creditor stated that the debtor was to give the creditor $51,877.00 in expected tax refunds. *Id.* at *2. However, the

[8] The court subsequently held, "[i]ntangible balance sheet assets, such as goodwill, which may have no market value (either on a liquidation or going concern basis) generally should be excluded from the calculation," without further discussing "goodwill." *Id.*

creditor did not receive any tax refunds because the taxing authorities kept them to satisfy the debtor's unpaid taxes. *Id.* Nonetheless, creditor's claim to those refunds constituted debt in calculating the debtor's solvency because the family law court retained jurisdiction over the tax matters and would "undoubtedly" adjust the rights in light of the fact that taxing authorities kept the refunds. *Id.*

Further, in *Village Concepts*, the Ninth Circuit bankruptcy court acknowledged "contingent liabilities are included in determining total indebtedness for purposes of deciding insolvency." *Village Concepts*, 2015 WL 8030974 at *10. However, this appellate court found that the lower court's failure to include contingent liabilities in an insolvency calculation was not clearly erroneous. *Id.* Debtor was in the business of selling new and used manufactured homes and managing mobile home parks. *Id.* at *1. At the time debtor made the alleged fraudulent transfer, 1) one of the people it sold a mobile home to had filed a state court complaint against the debtor for failing to make required construction repairs, and 2) an attorney had sent a letter to the debtor demanding $1,250,000.00 for defective construction of homes that people bought from the debtor. *Id.* The creditor in *Village Concepts* argued those potential constructive defect claims constituted potential liabilities that the lower court should have considered in calculating the debtor's insolvency. *Id.* at *9. The court disagreed, holding that said contingent liabilities were "indefinite, speculative, and not material" because debtor's president testified that he was unaware of any further litigation, did not receive the demand letter, and that even if he received the letter, it simply threatened a lawsuit. *Id.* at 10. Accordingly, the lower court did not clearly err by failing to include contingent liabilities in its insolvency analysis. *Id.*

A related issue in the insolvency examination is accessibility of assets, namely, the issue of whether out-of-reach assets are to be included._Two recent cases demonstrate courts will only consider something as an asset under the insolvency analysis if the funds are accessible and not out of reach. Thus, in *UC Lofts*, the court analyzed insolvency under the cash flow test, holding "[t]his analysis requires the court to scrutinize 'cash flow projections and other forward-looking sources of evidence available to the debtor and its creditors at the time of transfer.'" *UC Lofts*, 2015 WL 8030974 at *16 (quoting *In re Pajaro Dunes Rental Agency, Inc. v. Spitters, 174 B.R. 557, 593 (Bankr. N.D. Cal. 1994)*). Creditor was a trustee who sought to recharacterize the defendants' loans to the debtors/real estate companies as equity. *Id.* at *23. Defendants offered evidence that the debtors had substantial presales to prove that the debtors were solvent under the constructive fraud analysis. *Id.* at *16. However, the court found debtor understood that it would not realize any of the presale income unless it either sold the property or completed a separate real estate project. *Id.* Accordingly, the court refused to consider the presale evidence because "there [was] no indication that the [d]ebtors had ready access to [those] funds as a source of operational capital." *Id.*

Similarly, the recent Ninth Circuit holding in *In re Blixseth*, 2017 WL 929206, at *1 (9th Cir. Mar. 9, 2017) suggests that assets are included in an insolvency analysis if the creditor can access it as a remedy. In *Blixseth*, the creditor was a trustee that sought to avoid the debtor's guarantee of $13,000,000.00 that the defendant issued to the debtor. *Id.* The defendant/appellant appealed the district court's order affirming a bankruptcy court's judgment in favor of the creditor, and alleged that the bankruptcy court erroneously excluded the debtor's interest in her marital community when it calculated her solvency. *Id.* The court in *Blixseth* agreed and held that the bankruptcy court erred "[b]ecause the [the debtor]'s creditors could have reached her share of [such] property through legal process." *Id.* (citing *In re Marriage of Schenck*, 228 Cal. App.

3d 1474 (1991); Collier on Bankruptcy § 101.32 (16th ed. 2016) ("it is obvious that interests which are subject to creditors' remedies must necessarily be considered.")).

Key Tips and Takeaways for Fraudulent Transfers

- Identify all creditors, including contingent or potential creditors;
- Assess likelihood of a claim;
- Confirm proper notice procedures;
- Evaluate whether sufficient value in is being exchanged for the assets (e.g., hire an accountant to perform a pre-emptive valuation?);
- Evaluate selling company's solvency with documentation;
- Review facts in light of "badges of fraud";
- Review terms of any financing documents in light of risk of "recharacterization."