MEMORANDUM

FROM: The Avoidance Committee
TO: The National Bankruptcy Conference
DATE: October 30, 2021
RE: Fraudulent Transfer Proposals

The Avoidance Committee is making several proposals to the Conference relating to the avoidance of fraudulent transfers and the effects of avoidance.

I. ADDRESSING WHETHER FRAUDULENT TRANSFER RECOVERIES SHOULD BE LIMITED TO THE AMOUNT OF CREDITOR CLAIMS

Introduction

Fraudulent transfer law has traditionally been a creditor remedy designed to enable a creditor to recover on its claim against the debtor by way of access to the fraudulently conveyed property to the extent necessary to satisfy the creditor's claim.[1] While some bankruptcy cases have suggested that a recovery on a fraudulent transfer, whether under § 548 or § 544(b) (using state fraudulent transfer law), is not limited to the amount of creditor claims, other cases have suggested the opposite, consistent with state law. The decision on whether a recovery on a fraudulent transfer claim may or may not exceed a value based on the unsatisfied claims of creditors usually depends on how the court interprets the language in § 550 of the Bankruptcy Code referring to recovery "for the benefit of the estate."[2]

The Avoidance Committee has considered the issue of whether fraudulent transfer recoveries should be limited to the amount of creditor claims against the estate. There was some support in the Avoidance Committee for applying such a limit. The rationale for that position was that it goes as far as it can to preserve the benefit of a transferee's bargain with debtor, a bargain that would likely be respected under other law. As a general matter under non-bankruptcy law, a debtor cannot invoke fraudulent transfer law to recover property that the debtor itself has fraudulently transferred. Furthermore, the recovery of the value of the property in excess of the amount of creditor claims could create a windfall for the debtor or the debtor's equity holders.

However, the majority of the Avoidance Committee felt that limiting the recoveries to the amount of creditor claims against the estate may prejudice the estate or other creditors of the debtor in a number of circumstances. Several examples were cited where it would seem appropriate for the estate to retain the excess value and the limitation not to apply:

---

[1] *See, e.g.*, Uniform Voidable Transactions Act § 8(a)(1).

[2] *See, e.g., In re Physiotherapy, Inc*., No. 15-51238, 2017 WL 5054308, at *7-8 (Bankr. D. Del. 2017) (permitting recovery in excess of the amount of creditor claims); *contra*, *In re Allonhill, LLC*, 2019 WL 1868610 at *52 (Bankr. D. Del. 2019) (denying excess recovery and referring to the *Physiotherapy* decision as "advisory in nature").

- In a chapter 11 case, where the excess value is necessary for a reorganized debtor to be adequately capitalized and to confirm a plan as feasible.
- In a chapter 11 case, where creditors are receiving equity in the debtor and taking the risk that the value that creditors will ultimately realize for the equity will be less than the amount of the creditors' claims,
- Where <u>future</u> creditors (whose claims may arise only after the bankruptcy case is concluded and, therefore, are not part of the allowed claims receiving distributions in the case) have standing under state law to bring fraudulent transfer claims, as in the case of a transfer of assets by a debtor to an asset protection trust, and where no creditor at the time of the transfer exists at the commencement of debtor's bankruptcy case.
- Where the debtor is an individual and the excess value might be claimed by the debtor as an exemption.

Moreover, there is a serious practical impediment to implementing a limitation on recovery based on the aggregate amount of the allowed claims against the debtor's estate. The impediment arises from the different timelines applicable to claims resolution and to avoidance litigation. The claims allowance process (including with respect to substantial unliquidated claims and any appeals) may not be concluded until long after the fraudulent transfer litigation has gone to judgment. In addition, if there is more than one fraudulent transfer claim available to the debtor's estate representative, limiting recoveries to the amount of creditor claims may raise a timing issue as to when to count creditor claims and could perhaps unfairly subject one fraudulent transferee to a recovery that pays all creditors of the estate in full while another fraudulent transferee retains the full benefit of its bargain with the debtor.

<u>Proposal</u>

The Avoidance Committee instead is recommending another approach depending on whether the transfer is a "constructive" fraudulent transfer or an "intentional" one. The recommendation does not affect current law on (a) whether the transferee may be compelled to return the property to the debtor's estate or, alternatively, merely pay the value of the property to the debtor's estate, (b) the right of a good faith transferee of property fraudulently transferred who returns the property to the estate to retain a lien on the property under Bankruptcy Code § 548(c) or state law for the amount of consideration paid by the transferee, or (c) any right of a bad faith transferee of property fraudulently transferred, who returns the property or pays its value to the estate, to a prepetition claim under applicable substantive law and Bankruptcy Code § 502(h) for the amount of the consideration paid by the transferee for the avoided transfer.[3]

---

[3] As a general matter, a transferee of fraudulently transferred property is entitled to a reinstatement claim under Bankruptcy Code § 502(h) for the consideration paid. S*ee In re Solidarity Contracting, Inc.*, 2019 WL 6173690 (Bankr. S. D. Tex. 2019) at *3 and cases cited therein; *In re Tronox Inc*. 503 B.R. 239 (Bankr. S.D.N.Y. 2013). The *Tronox* court stated that "[section 57g of the former Bankruptcy Act, [the] predecessor to [section] 502(h) "was not designed to punish a creditor who had sought to withhold the debtor's assets from the bankruptcy estate…[i]f after adjudication he surrenders the assets thus acquired to the court, he may share on a parity with other creditors." *Id.* at 330 (quoting *In re Onondaga Litholite Co.*, 218 F.2d 671, 673 (2d. Cir 1955).

The same result has been applied even when the transferee has acted in bad faith. *Misty Management Corp. v. Lockwood*, 539 F.2d 1205, 1214 (9th Cir. 1976) (a transferee guilty of fraudulent behavior is entitled to a claim against the debtor if he returns the property to the estate. "A rule to the contrary would allow the estate to recover the voidable

Constructive fraudulent transfer

Consider the following example:

Debtor transfers to Transferee property worth $1 million for a cash purchase price of $400,000. Within two years following the transfer, Debtor commences a bankruptcy case, and Debtor's estate representative brings a fraudulent transfer lawsuit against Transferee seeking the return of the property under Bankruptcy Code § 550. No improvements have been made to the property since the transfer. From Debtor's assets (excluding the avoidance action), all creditors of the estate will be paid in full but for a shortfall in payment of claims totaling $200,000.

If the recovery from Transferee is limited to $200,000, then, depending upon the circumstances, (a) Transferee may be required to return the property to the estate and, if Transferee acted in good faith, Transferee may then retain a lien on the property for $800,000 under Bankruptcy Code § 548(c) or state law,[4] or (b) Transferee may be required to pay $200,000 to the estate but would retain the property. Transferee would not have a claim against the estate for $200,000. This result arguably balances the need to satisfy creditor claims while preserving for Transferee, to the maximum extent, the benefit of its bargain with Debtor.

If the recovery from Transferee is not limited to $200,000, then, depending upon the circumstances:

- If Transferee had acted in good faith, Transferee may be required to return the property to the estate but would then retain a lien on the property for $400,000 under § 548(c) or state law, or Transferee may be required to pay $600,000 to the estate but would retain the property.[5] Transferee would not have a claim against the estate for $600,000.
- If Transferee had not acted in good faith, Transferee may be required to return the property to the estate or Transferee may be required to pay $1 million to the estate but would retain the property. Transferee would likely have a claim against the estate but limited to $400,000.

---

conveyance and to retain whatever consideration it had paid therefor. Such a result would clearly be inequitable."); *see also In re Walldesign, Inc*., No. BAP CC-17-1290-KUFS, 2018 WL 3653877, at *5 (B.A.P. 9th Cir. Aug. 2, 2018) (same); Gerald K. Smith, "Avoidance Actions and Claims of Creditors that Become Property of the Estate," 1995 *Ann. Surv. of Bankr.Law* 30, citing Glenn, *Fraudulent Conveyances* § 260a (1940), but conceding that the result is left to inference under the Bankruptcy Code.

[4] Arguably, Transferee would not be able to retain a lien on the property to secure the full $800,000 since the consideration paid by Transferee was only $400,000. However, if Transferee's lien was limited to securing $400,000, then to give effect to the $200,000 limitation on recovery, Transferee would nevertheless be entitled to an unsecured claim for $400,000 which would be paid in full.

[5] Although Bankruptcy Code § 548(c) gives the good faith transferee a lien on the interest transferred, it does not expressly provide to the good faith transferee a credit if the transferee is ordered to pay the value of the property instead of being ordered to return it. *See* Bankruptcy Code § 550 addressing the alternative of requiring the transferee to pay the value of the property transferred but without reference to any credit for the consideration paid by the good faith transferee. Yet, it would seem like the right result for the transferee to receive the credit.

This result does not respect the benefit of Transferee's bargain with Debtor and arguably produces a windfall for Debtor or its equity holders. However, this result could avoid the situations of concern to the Avoidance Committee, as stated above, where limiting the recoveries to $200,000 might not be appropriate.

In weighing these two competing outcomes, the Avoidance Committee is recommending a middle approach. Under this approach, the recovery would not be limited to $200,000. Depending on the circumstances, Transferee may be required return the property to the estate and, if Transferee acted in good faith, Transferee may retain a lien on the property for $400,000 under Bankruptcy Code § 548(c) or state law, or Transferee may be required to pay $600,000 or, if it had not acted in good faith, $1 million to the estate, and Transferee may then retain the property. However, under the approach recommended by the Avoidance Committee, Transferee would be entitled to a claim against Debtor's estate for $600,000 that would be subordinated to the claims of the other creditors.[6]

This approach – an uncapped recovery for Debtor's estate with Transferee being given a subordinated claim against the estate for the amount by which either the value of the fraudulently transferred property returned to the estate by Transferee, or the payment made by Transferee to the estate, as applicable, exceeds the amount of the consideration paid by Transferee - would provide the estate with the excess value of the recovery without resulting in a windfall for Debtor or Debtor's equity holders.[7] It would also avoid the practical difficulties in implementing a limitation on recovery where the fraudulent conveyance suit proceeds to judgment long before the claims allowance process has concluded or in dealing with multiple fraudulent transfer claims, any one of which, if successful, would enable creditors to be paid in full. This approach would not

---

[6] If Transferee had not acted in good faith, and Transferee had returned the property or paid $1 million to the estate, Transferee would also have a general unsecured claim against the estate for $400,000 as under current law.

[7] The hypothetical assumes that there have been no improvements to the property. If Transferee has made improvements and had returned the property to the estate, Transferee would likely have a claim against the estate for the value of the improvement and any increase in market value of the property attributable to the improvements. If Transferee has acted in good faith, then, under Bankruptcy Code § 550(e), Transferee's claim relating to the improvements would be secured by a lien on the property. If, instead of returning the property to the estate, Transferee paid to the estate the value of the property less the consideration paid by Transferee, then, based on the same rationale as in footnote 5, Transferee would be entitled to deduct the value of the improvements, and any increase in market value of the property attributable to the improvements, from the amount paid to the estate.

The hypothetical also assumes that, wholly apart from the value of any improvements and any increase in market value of the property attributable to the improvements, the market value of the property has not changed since the time of the acquisition of the property by Transferee. As a general matter under fraudulent transfer law, the value of the property would be determined at the time of the transfer to Transferee. *See* Uniform Voidable Transactions Act § 8(c). If, wholly apart from any increase in market value of the property attributable to improvements, the market value had increased between the time when the property was acquired by Transferee and the time when Transferee returned the property to the estate, Transferee's subordinated claim would be increased by the amount of the increase in market value of the property. Otherwise, Debtor or Debtor's equity holders would receive a windfall in the amount of the increase in value. If the value of the property had decreased, the estate representative would likely seek from Transferee a judgment equal to the value of the property at the time of transfer less the consideration paid by Transferee. If Transferee paid the judgment, Transferee's subordinated claim would be in the amount of the judgment.

dilute the claims of Debtor's other creditors that would otherwise occur if Transferee were given a claim for $600,000 that was not subordinated.[8] Those other creditors would effectively be placed back in the position that would have existed had the fraudulent transfer not been made. And the other creditors would not be placed in a worse position by a *pari passu* claim of Transferee, anchored in the fraudulent transfer, for the shortfall between the consideration received by Debtor as compared to the consideration given by Debtor. To the extent that the recovery renders Debtor's estate solvent but for Transferee's subordinated claim, and creditors of a solvent estate would be entitled to postpetition interest, the other creditors of Debtor's estate would be so entitled under this approach.

However, this approach would also provide Transferee with a claim for the excess value, a claim that Transferee might not otherwise have under the Bankruptcy Code[9] or applicable state law.[10] The claim would be a direct benefit to Transferee in partial compensation for the recovery against Transferee not being limited by either (i) the amount of creditor claims against the estate or (ii) under § 544(b) and *Moore v. Bay*, the amount of the claim of an actual creditor entitled to assert the fraudulent transfer claim under state law.

This approach would seem to work well in most bankruptcy cases where creditors are being paid in cash. However, the approach could become more complicated in a chapter 11 case if Debtor's other creditors are not being paid in cash but rather in securities issued by Debtor as reorganized, or the other creditors are being paid in beneficial interests in a litigation trust. The Avoidance Committee considered some solutions in these circumstances.

Securities issue in a chapter 11 case generally. If in a chapter 11 case Debtor's other creditors are not being paid in cash but rather in securities issued by Debtor as reorganized, Transferee might receive for its $600,000 claim the same securities being issued to Debtor's other creditors and valued in the same manner as for the other creditors, at $600,000, except that the securities issued to Transferee would be junior to the securities issued to other creditors.[11] In such a case, even though, excluding Transferee's subordinated claim, Debtor may be rendered solvent

---

[8] If Transferee were given an unsubordinated claim for $600,000, the shortfall in payment of creditor claims in our example would still be $200,000. Transferee's subordinated claim would rank ahead of a claim subordinated under Bankruptcy Code § 510(b) to the extent that general unsecured claims would rank ahead of the Bankruptcy Code § 510(b) subordinated claim. Whether Transferee's subordinated claim ranks ahead of a claim equitably subordinated under Bankruptcy Code § 510(c) may depend on the facts of the case. This proposal does not require that any claim that Transferee may have for the $400,000 in consideration paid be subordinated as well; the treatment of that claim is left to current law.

[9] Once again, any reinstatement claim that Transferee might make under Bankruptcy Code § 502(h) would be limited to the $400,000 paid by Transferee.

[10] *E.g.*, the Uniform Voidable Transaction Act does not provide Transferee with a claim against Debtor. Perhaps Transferee could fashion an unjust enrichment or similar claim against Debtor. However, that claim would likely be avoidable as having been incurred by Debtor for less than reasonably equivalent value at a time when Debtor was left insolvent or with unreasonably small capital.

[11] If Transferee were issued unsubordinated securities valued at $600,000, the amount of Debtor's unsubordinated claims would exceed the value of Debtor's assets by $200,000. The recovery for Debtor's other creditors would be diluted even if the securities ultimately yielded cash equal to the claims of all creditors.

if the valuation of the securities is correct, the valuation risk of the securities would be borne in the first instance by Transferee, to the point where the junior securities received by Transferee were or became worthless. Thereafter the risk would be shared by the other creditors. If the reorganized Debtor succeeds, all creditors would benefit. If the reorganized Debtor does not succeed, the abrogation of the limit provides some downside protection to the creditors other than Transferee.

Common equity securities issued to other creditors. If the other creditors are receiving securities consisting of the common equity in Debtor as reorganized, it may seem to some as anomalous for Transferee to receive securities subordinated to the common equity securities. However, Debtor's plan could provide for the other creditors to receive, for example, Class A common shares and for Transferee to receive Class B common shares. The Class A common shares would be entitled to all distributions from Debtor until the other creditors have recovered the amount of their original claims plus interest post-effective date at a market rate. After that recovery, the Class B common shares would be entitled to all distributions from Debtor until Transferee has received the amount of its subordinated claim plus interest at the same rate. Thereafter, the Class A and Class B common shares would be entitled to all distributions from Debtor ratably.

Litigation trust. The same concept might work if the fraudulent transfer claim against Transferee were assigned by Debtor's estate to a litigation trust under Debtor's plan. Debtor's plan could provide for the other creditors to receive Class A beneficial interests in the litigation trust and for Transferee to receive Class B beneficial interests. The Class A beneficial interests would be entitled to all distributions from the trust until the other creditors have recovered the amount of their original claims plus interest post-effective date at a market rate. After that recovery, the Class B beneficial interests would be entitled to all distributions from the trust until Transferee has received the amount of its subordinated claim plus interest at the same rate. Thereafter, the Class A and Class B beneficial interests would be entitled to all distributions from the trust ratably.

Intentional fraudulent transfer

The Avoidance Committee would not change the recommendation for an intentional fraudulent transfer by Debtor from that for a constructive fraudulent transfer except in two instances. The first would be if Transferee did not act in good faith. In that situation, Transferee would not only lose the lien on the property that it would otherwise have under Bankruptcy Code § 548(c), but Transferee also would not have a subordinated claim for $600,000 against Debtor's estate. The second instance would be if the transfer was avoidable under Bankruptcy Code § 548(e), such as where the transfer is to a trust for the benefit of Debtor.[12]

In these two situations, the Avoidance Committee believes that Transferee does not deserve a subordinated claim. If Transferee did not act in good faith, there is no policy reason to compensate Transferee with a subordinated claim that it would not otherwise be entitled to under the Bankruptcy Code or state law. If Transferee were a self-settled trust or similar device, a

[12] A proposal to expand Bankruptcy Code § 548(e) is made in Part II.

subordinated claim would, albeit indirectly, unjustly enrich Debtor, and perhaps other beneficiaries affiliated with Debtor, at the expense of Debtor's future creditors.

II. SELF-SETTLED TRUSTS - BANKRUPTCY CODE § 548(e)

Introduction

Section 548(e) of the Bankruptcy Code provides for a 10-year look-back period, instead of the otherwise applicable two-year look-back period in Bankruptcy Code § 548(a), for an intentional fraudulent transfer by a debtor to a self-settled trust or similar device of which the debtor is a beneficiary. The term "similar device" is not defined. The term leaves some ambiguity as to whether a "similar device" includes or excludes a trust for the benefit of a third party, such as an insider or affiliate of the debtor, but from which the debtor retains or would reasonably expect to receive an interest, such as a contingent residual interest. The Committee believes that the phrase "similar device" was intended to address such an arrangement.

The Committee also believes that the "similar device" reference should include an arrangement by which the debtor derives or expects to derive an interest in a beneficiary of the trust following the transfer, as, for example, when the debtor transfers property to a trust for the benefit of a corporation whose shares are owned by the debtor.

Proposal

The Committee recommends that Bankruptcy Code § 548(e)(1) be modified to read as follows:

(1) In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if—
(A) such transfer was made to a self-settled trust or similar device;
(B) such transfer was by the debtor;
(C) the debtor is a beneficiary of such trust or similar device <u>or the debtor otherwise has, receives or would reasonably be expected to receive an interest or other benefit from the trust or device or from another beneficiary's interest in the trust or device</u>; and
(D the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.

The Committee also recommends that Bankruptcy Code § 550 be amended by adding the following new subsection:

(g) For purposes of subsection (a), the term "initial transferee" includes the debtor to the extent that the debtor is an immediate or mediate transferee of a transfer avoidable under section 548(e).

The Committee considered as well, at the request of the Conference, whether Bankruptcy Code § 548(e)'s 10-year look-back should apply more expansively if the fraudulent transfer were to a device similar to a self-settled trust of which the debtor's family members or other insiders were the only beneficiaries even if the debtor did not retain or expect to receive an interest in the similar device. The literal reading of Bankruptcy Code § 548(e) essentially permits the debtor to structure an intentional fraudulent transfer to a device similar to a self-settled trust but for the benefit of the debtor's family members or other insiders rather than the debtor and thereby evade the 10-year look-back period. Arguably, there is no policy reason for the 10-year look-back period to apply only when the debtor is a beneficiary, and not when family members or other insiders of the debtor whose interests are aligned with those of the debtor in protecting family wealth from the debtor's creditors are beneficiaries.

However, the Committee is concerned that the expansion of Bankruptcy Code § 548(e) in this way might interfere with customary estate planning strategies by which a debtor might transfer property to an irrevocable family trust, of which the debtor is not a beneficiary, with the view to reducing potential estate taxes, avoiding probating the property as part of the debtor's estate, or establishing funds to care for an elderly or disabled relative or for the education of a relative. The Committee believes that (a) these family trust and like customary estate planning techniques should not be viewed to be an asset protection trust or similar device for purposes of § 548(e) and (b) the implementation of such customary estate planning strategies solely for such purposes should not meet the "actual intent" requirement of § 548(e)(i)(D).

The Committee believes that, on a broader scale, such an expansion could possibly interfere with customary estate planning techniques that have generally not been controversial. Absent an expansion, the two-year look-back period in Bankruptcy Code § 548(a), or, through Bankruptcy Code § 544(b), longer look-back periods under state voidable transactions laws, will still apply to capture the "bad actors."

III. TRANSFER OF AN ASSET BY A SOLVENT DEBTOR SUBSIDIARY

Introduction

Consider the following hypothetical:

Debtor, a corporation, is insolvent but owns a solvent subsidiary. The subsidiary transfers some of its assets to Debtor's shareholders for less than reasonably equivalent value. After the transfer, the subsidiary is still solvent.

The effect of the transaction is to siphon off value available to Debtor's creditors by reducing the value of Debtor's ownership interest in the subsidiary. If instead Debtor had distributed some of the shares of the subsidiary to Debtor's shareholders, the distribution would have likely been viewed as a fraudulent transfer. Yet courts have held that, when Debtor's subsidiary conveys its own assets, there has been no transfer "by the debtor" that is susceptible to a successful fraudulent transfer challenge by creditors of Debtor.[13] This is the case notwithstanding that the definition of "transfer" in Bankruptcy Code § 101(54) is quite broad and includes, among other things, each mode of disposing or parting with property or an interest in property whether direct or indirect.

[13] *See, e.g., Crystallex International Corp. v. Petróleos de Venezuela, S.A.*, 879 F.3d 79 (3d Cir. 2018).

Proposal

The Committee believes that the definition of "transfer" in Bankruptcy Code § 101(54) is sufficiently broad to encompass the indirect transfer of the subsidiary's assets to Debtor's shareholders as a dividend of the excess value of the assets to Debtor (first leg) and in turn a distribution by Debtor to Debtor's shareholders (second leg). Under this approach, the distribution on the second leg would be avoidable as a fraudulent transfer.

The result can be made more explicit by adding the following sentence to the definition of "transfer" in Bankruptcy Code § 101(54):

The term includes, in relation to a transfer by a debtor, a distribution of value from an entity in which the debtor has a controlling interest to or for the benefit of an entity which has an interest in the debtor or an affiliate or insider of such entity.

However, the Committee does not believe that such an amendment is necessary. Given the broad definition of "transfer," any expansion of the definition may inadvertently be read to exclude other transfers that already fit within the broad definition.

IV. INCURRENCE OF AN OBLIGATION BY A SOLVENT DEBTOR SUBSIDIARY

Introduction

Consider the following hypothetical:

Debtor, a corporation, is insolvent but owns a solvent subsidiary. Debtor borrows funds from Lender, and the subsidiary guaranties the loan. Debtor then distributes the proceeds of the loan to Debtor's shareholders. After giving effect to the guaranty, the subsidiary is still solvent. Lender's loan is challenged in Debtor's bankruptcy case as a voidable transaction, but Lender claims that, if the transaction is successfully avoided, Lender nevertheless has recourse to the subsidiary on the guaranty.

If Lender's claim to recourse on the subsidiary's guaranty is successful, the effect of the guaranty is to siphon off value available to Debtor's creditors other than Lender by reducing the value of Debtor's ownership interest in the subsidiary. If instead Debtor had received a dividend from the subsidiary and paid the dividend to Debtor's shareholders, the dividend paid by Debtor would have likely been viewed as a fraudulent transfer. Yet courts have held that, when Debtor's subsidiary incurs the guaranty obligation, there has been no incurrence of an obligation "by the debtor" that is susceptible to a voidable transaction challenge by Debtor's estate representative.[14]

Proposal

[14] *See, e.g.*, *Adelphia Recovery Trust v. Bank of America, N.A.*, 390 B.R. 80 Bankr. S.D.N.Y. 2008). Arguably also, absent recharacterization of the transaction, Bankruptcy Code § 101(54) may not capture the transaction as a "transfer" since the transaction involved the incurrence of an obligation rather than a transfer of property.

Arguably, the transaction could be recharacterized as a "transfer" since the net effect of the transaction is to transfer a portion of the value of Debtor's equity interest in the subsidiary for the benefit of Debtor's shareholders. However, a majority of the Committee believe that such a recharacterization would be beyond even the robust breadth of the definition of "transfer."

Instead, the Committee recommends that Bankruptcy Code § 548(d)(1) should be amended by adding the following:

(F) If the debtor, or an affiliate or insider of the debtor, incurs an obligation to a third party guaranteed by an entity in which the debtor has a controlling interest or such an entity otherwise becomes liable with the debtor or an affiliate or insider of the debtor on, or secures, a claim of a creditor against the debtor or an affiliate or insider of the debtor, and the guaranty obligation or other liability is incurred, or the lien is granted, for the benefit of an entity which has an interest in the debtor or for the benefit of an affiliate or insider of such entity, the guaranty obligation or other liability or lien may be avoided under this section to the same extent as if the guaranty obligation or other liability had been incurred, or the lien had been granted, by the debtor itself.

V. DIVISIONS AND DIVISIVE MERGERS

Background

The entity laws of several states permit an entity organized under the laws of that state to effect a "division" or "divisive merger" by which the entity can be divided into two[15] separate entities with the assets and liabilities of the original entity being allocated between the two entities under a so-called "plan of allocation." Delaware provides for a "division" by a limited liability company organized under Delaware law.[16] Arizona,[17] Pennsylvania,[18] and Texas[19] provide for a "division" or "divisive merger" for corporations and other entities organized under the laws of those states.

Concerns have been raised, especially where an entity is a defendant or potential defendant in a mass tort case, that the entity can opportunistically divide its assets and liabilities to shelter its good assets from the claims of its creditors. Let's say that Company has two businesses which, combined, have a positive net worth – (1) a good business that has few claims against it and a positive net worth and (2) a bad business which has massive claims against it and a negative net worth. Company effects a division by which the good business with its assets and associated liabilities are placed in one of the companies resulting from the division (the "<u>Good Company</u>") and the bad business with its assets and associated liabilities are placed in the other company resulting from the division (the "<u>Bad Company</u>"). Following the division, under the entity laws of the particular state, the mass tort or other creditors whose claims arose from the bad business of Company have recourse only to the assets of the Bad Company.

---

[15] Conceivably more than two entities may result from the division or divisive merger. For convenience, we illustrate the issues assuming that only two entities result. The analysis in this Part is the same if more than two entities result.
[16] 6 DE Code §18-217.
[17] 29 Ariz. Rev. Stat. § 2601 *et seq.*
[18] 15 Pa.C.S.A. Ch. 3, subchapter F.
[19] Texas Business Organizations Code § 10.008.

In such a situation, a fraudulent transfer challenge to the division seems highly plausible. Before the division, the mass tort and other creditors whose claims arose from the bad business had recourse to the assets of Company with a positive net worth. After the division, the mass tort or other creditors whose claims arose from the bad business have recourse only to the assets of Bad Company with a negative net worth. The effect of the division is substantially the same as if the good assets of Company had been spun off to new subsidiary followed by the equity interests in the subsidiary being transferred to the shareholders of the parent. A spin-off transaction may be subject to a fraudulent transfer challenge in appropriate circumstances.[20] The effect of a division would appear to be analogous but with the added effect of creating a statutory novation to the Bad Company of the claims arising from the bad business.[21] The attributes of a division would appear to fall within the broad definition of the term "transfer" under both the Bankruptcy Code[22] and the Uniform Voidable Transactions Act.[23] Both definitions refer to "every mode" of transfer and contemplate that the "transfer" might be "direct or indirect."

The possibility of a fraudulent transfer challenge to a division has not gone unnoticed. The division statute of each of Delaware and Pennsylvania provides that allocation of liabilities between the entities resulting from the division is not effective if the allocation is a fraudulent transfer.[24] The Arizona division statute goes even further. It generally retains joint and several liability for the companies subject to the division absent consent of the creditor or recourse being limited under other law.[25]

The Texas divisive merger statute, however, has no fraudulent transfer carve-out to the allocation of assets and liabilities and refers to the divisive merger becoming effective without any "transfer" occurring.[26] It has been argued that the Texas divisive merger act, by both omitting a reference to the Texas Uniform Fraudulent Transfer Act and stating that a divisive merger can become effective without any "transfer" occurring, might permit an interpretation that the divisive merger statute overrides the Texas Uniform Fraudulent Transfer Act.[27] However, such an interpretation is unlikely to be persuasive. The Texas Uniform Fraudulent Transfer Act contains the uniform broad definition of the term "transfer" for purposes of that act. Furthermore, a general provision of the Texas Business Organization Code, in which the divisive merger statute is located, provides: "This code does not … abridge any right or rights of any creditor under existing law."[28]

---

[20] *See, e.g.,* "Backspin: Challenging Spin-Offs as Fraudulent Transfers,: *Latham & Watkins Client Alert Commentary* (January 22, 2016 | Number 1917), available at https://www.lw.com/thoughtLeadership/LW-Backspin-Challenging-Spin-Offs-as-Fraudulent-Transfers.

[21] In a spin-off the company receiving the assets spun off assumes specified liabilities associated with those assets, but the original company remains secondarily responsible for those liabilities under suretyship law. *See Restatement (Third) of Suretyship & Guaranty* § 1. In a division or divisive merger, the liabilities of Company associated with the bad business are novated to the Bad Company with the Good Company being released from those liabilities under the statutorily-validated plan of allocation.

[22] Bankruptcy Code § 101(54).

[23] UVTA § 1(16). The Uniform Fraudulent Transfer Act has the same definition of "transfer."

[24] 6 DE Code §18-217(f)(5); 15 Pa. C.S.A. § 368(d).

[25] 29 Ariz. Rev. Stat. § 2607.

[26] Texas Business Organizations Code § 10.008(2)(C).

[27] *See* Adam Levitin, "The Texas Two-Step: The New Fad in Fraudulent Transfers," posted at *Credit Slips* (July 19, 2001), available at https://www.creditslips.org/creditslips/2021/07/the-texas-two-step.html.

[28] Texas Business Organizations Code § 10.901.

In any event the Texas divisive merger statute would not override Section 548 of the Bankruptcy Code, a federal statute.

Moreover, even those companies using or contemplating using [29] the Texas divisive merger statute to create the Good Company and the Bad Company[30] do not rely on the Texas divisive merger statute alone to insulate the Good Company from a successful fraudulent transfer challenge. Typically, the Good Company will provide a contractual funding commitment or indemnity to the Bad Company for any pre-division claims that are not ultimately satisfied, albeit with the funding commitment or indemnity subject to limitations and conditions. Even the Good Company providing a full contractual funding commitment or indemnity, though, arguably leaves creditors of the Bad Company with less leverage to negotiate a favorable settlement of their claims than if there had been no division or divisive merger at all.

To address concerns about opportunistic uses of a division or divisive merger to prejudice creditors of the dividing entity, bills in Congress have proposed, in effect, to deny the Bad Company access to the Bankruptcy Code. Under the bills, a bankruptcy case in which the Bad Company is the debtor could be dismissed at the request of any party of interest if the division or the divisive merger had occurred at any time during the 10-year period preceding the commencement of the case.[31]

Proposal

The majority of the Committee does favor a legislative solution, but not, as in the current bills before Congress, one of denying access to the Bankruptcy Code for a company resulting from a division or a divisive merger. There may be appropriate reasons for a company to effect a division or divisive merger that have nothing to do with prejudicing creditors. The reasons may involve formulation of new business models or anti-trust, tax planning or regulatory compliance considerations. Viewing all divisions and divisive mergers as prejudicial to creditors may be simplistic given the many reasons for such transactions.[32] In addition, bankruptcy might enhance recoveries for creditors of the Bad Company, because bankruptcy law permits the representative

[29] Building supply company CertainTeed Corporation's Texas divisive merger is being challenged as a fraudulent transfer in a bankruptcy court in the Western District of North Carolina in the bankruptcy case of DBMP LLC, in a situation where the company allocated asbestos liabilities in the divisive merger. Johnson & Johnson recently used a Texas divisive merger with a view to shed itself of talc related liabilities. The talc plaintiffs were unsuccessful in seeking to enjoin the transaction in advance of its being implemented. The resulting debtor, LTL Management LLC, is now subject to a bankruptcy case in the Western District of North Carolina.

[30] To take advantage of the Texas divisive merger statute, an entity organized under the law of another state would first convert to a Texas entity before effecting the divisive merger – a so called "Texas two-step."

[31] The House and Senate bills proposing the "Nondebtor Release Prohibition Act of 2021" are nearly identical in relation to divisions and divisive mergers. The bills were proposed by Senators Elizabeth Warren (D-Mass.), Dick Durbin (D-Ill.), and Richard Blumenthal (D-Conn.) and Representatives Jerrold Nadler (D-NY) and Carolyn B. Maloney (D-NY).

[32] One member of the Committee was involved in a Texas two-step transaction designed to achieve state sale and use tax savings while still satisfying amounts owed to creditors of the companies resulting from the divisive merger. A division or divisive merger may also be used creatively in structured finance transactions, once again with no contemplation of failing to satisfy amounts owed to creditors of the companies resulting from the division or divisive merger. Furthermore, a division or divisive merger might be a legitimate way to separate out, and preserve, valuable rights under contracts that include *ipso facto* clauses that would be enforceable under the Bankruptcy Code in the event of a bankruptcy filing or that could otherwise be jeopardized by a bankruptcy filing.

of the estate created upon the filing of the bankruptcy case (or a committee given derivative standing to pursue estate causes of action) to bring avoidance claims on behalf of all creditors. Such claims could include not only state law voidable transaction claims but also avoidance claims provided by the Bankruptcy Code itself. Furthermore, denying a resulting company access to the Bankruptcy Code may encourage states that have enacted division or divisive merger statutes to enact additional legislation to permit state-sponsored rehabilitation schemes for entities organized under the laws of those states.

Instead, a majority of the Committee favors amending Bankruptcy Code § 1104(a) to provide for (a) a presumption that the appointment of an operating trustee is in the best interest of creditors if the debtor is the result of a division or divisive merger that occurred during the two-year period preceding the petition date and (b) the burden of rebutting the presumption to be on the debtor. The reasons for this recommendation are as follows:

Appointment of an operating trustee. The appointment of an operating trustee would address the self-dealing concern, i.e., that the debtor is largely being controlled by one or more other entities in the company group, making suspect of self-dealing any decision by the debtor to (i) bring or refrain from bringing a fraudulent transfer claim arising out of the division or divisive merger or pursuing other the remedies on behalf of creditors prejudiced by the division or divisive merger,[33] (ii) enforce or refrain from enforcing any funding commitment or indemnity in favor the debtor from any other entity in the company group, or (iii) formulate a plan to resolve claims of creditors prejudiced by the division of the divisive merger.

The two-year look-back period. If the division or divisive merger was planned with a view to prejudicing creditors, the likelihood of a near-term bankruptcy of the Bad Company arising out of the division would appear to be high, so that longer term litigation by creditors is stayed. Indeed, in cases so far, the commencement of the bankruptcy case by the Bad Company under the "Texas two-step' has occurred within days or a few weeks following the divisive merger. Given the fraudulent transfer concern arising from a division or divisive merger, the two-year look-back period is consistent with the two-year look-back period in Bankruptcy Code § 548.

Presumption against the debtor and burden on the debtor. Placing the burden on the debtor to rebut the presumption that the appointment of an operating trustee is in the best interest of creditors, and to demonstrate that leaving the debtor in possession would be in the best interest of creditors, appears to be appropriate. The availability of a division or divisive merger creates an attractive opportunity for Company to shed liabilities associated with its bad business to the prejudice of creditors of the bad business. Company may think twice about such an ill-motivated division or divisive merger in the face of the substantial risk that control of the Bad Company will pass to an independent third party with no reason to do Company's bidding, and who will likely be adverse to the Good Company. Moreover, Company would have to consider the substantial risk that, upon the likely appointment of a trustee, the Good Company or another company in the group would face the Hobson's choice of (i) funding administrative expenses of the Bad Company, including the fees of the trustee and the trustee's professionals in litigating against Company,

[33] In the bankruptcy case of DBMP LLC, the asbestos claimants were granted derivative standing to bring such claims. But the court warned the claimants that the Court of Appeals may determine that only a trustee is permitted to bring the claims.

resulting in Company funding litigation against itself, or (ii) facing dismissal by the court of the Bad Company's bankruptcy filing for lack of funds to pay administrative expenses, and being unprotected from suits arising out of the division or divisive merger by the automatic stay or any third party injunction of the bankruptcy court. If the division or divisive merger was motivated by a reason other than prejudicing creditors, the debtor should have the burden of showing that such was the case and that leaving the debtor in possession would be in the best interest of creditors.

One member of the Committee also suggested that, if a court finds that the debtor has rebutted the presumption, any denial of a motion for the appointment of an operating trustee should be a final order, permitting an immediate appeal of the denial during the course of the bankruptcy case.

However, several members of the Committee disfavor any legislative solution to the issue of divisions and divisive mergers at this time. Developments on how courts will deal with divisions and divisive mergers, whether through the application of fraudulent transfer laws[34] or otherwise,[35] are still in their embryonic stages. Given that courts have generally dealt successfully with spin-offs using existing legal tools and principles, legislative action on divisions and divisive mergers now may be premature. Especially in view of plausible uses of divisions and divisive mergers for purposes that do not prejudice creditors, these members of the Committee believe that the proposal of the majority for a presumption of an operating trustee is too draconian an approach at this time.

Although such views are not without merit, the majority of the Committee believes that the application of such traditional measures would take an undue amount of time, with creditor recoveries being unfairly reduced by the passage of time and with incentives to compromise. Additionally, as with any novel legislative provision, the time taken would permit competing and contrasting views to be expressed, to the detriment of creditors directly affected by the division or divisive merger.

The Committee also considered, but is not recommending at this time, other possible ways of addressing abuse arising from a division or divisive merger. These might include (a) extending the two-year Bankruptcy Code § 548 fraudulent transfer reach-back period with respect to a

[34] A narrow reading of the term "transfer" for purposes of Bankruptcy Code § 548 or state fraudulent transfer law may prove to be an obstacle to any fraudulent transfer claim. Bad Company will not itself have made a transfer. The transfer will have been made by Company which is not a debtor. The estate representative of Bad Company may not have standing to pursue fraudulent transfer claims that creditors may have to avoid the transfer by Company absent assignment of those claims to the estate representative. *See Caplin v. Marine Midland Grace Trust Co.,* 406 U.S. 416 (1972). While the estate representative may have standing to avoid as a voidable transaction the incurrence by Bad Company of its obligations to pay creditors whose claims arose from the bad business, avoiding those obligations will not likely help creditors harmed by the division or divisive merger. Indeed, since Company was released from those obligations under the "plan of allocation," there may even be an argument that the creditors' claims have in effect been extinguished by the avoidance. In the LTL Management LLC case, the debtor, Bad Company under our hypothetical, is seeking a stay on talc claims litigation against other Johnson & Johnson affiliates.

[35] In the bankruptcy case of DBMP LLC, the asbestos claimants have moved to substantively consolidate Certain Teed Corporation *nunc pro tunc* with DBMP LLC on the theory that the equities favoring reversing a divisive merger are even more compelling than in a traditional substantive consolidation. In a traditional substantive consolidation, third party creditors were often misled *ex ante*, by intentional or negligent actions of one or more companies in a group, into believing that they were dealing with a good company in the group when they were actually dealing with a bad company in the group. In a divisive merger, the creditors actually knew the company with which they were dealing *ex ante* but found, by the intentional (not merely negligent) actions of the company *ex post*, that their recourse was limited to the Bad Company as a result of the divisive merger.

fraudulent transfer action against the Good Company, (b) shifting the burden of proof to the Good Company to prove the absence of a fraudulent transfer, including the absence of intent to hinder, delay or defraud creditors, or (c) possibly expanding the definition of "transfer" in the Bankruptcy Code itself expressly to capture a division or divisive merger. This latter approach should be taken with caution out of concern, as discussed above, that the definition of "transfer" is already quite broad and that any expansion of the definition to address specific transactions may inadvertently be read to exclude other, similar transactions that already fit within the broad definition of "transfer.".