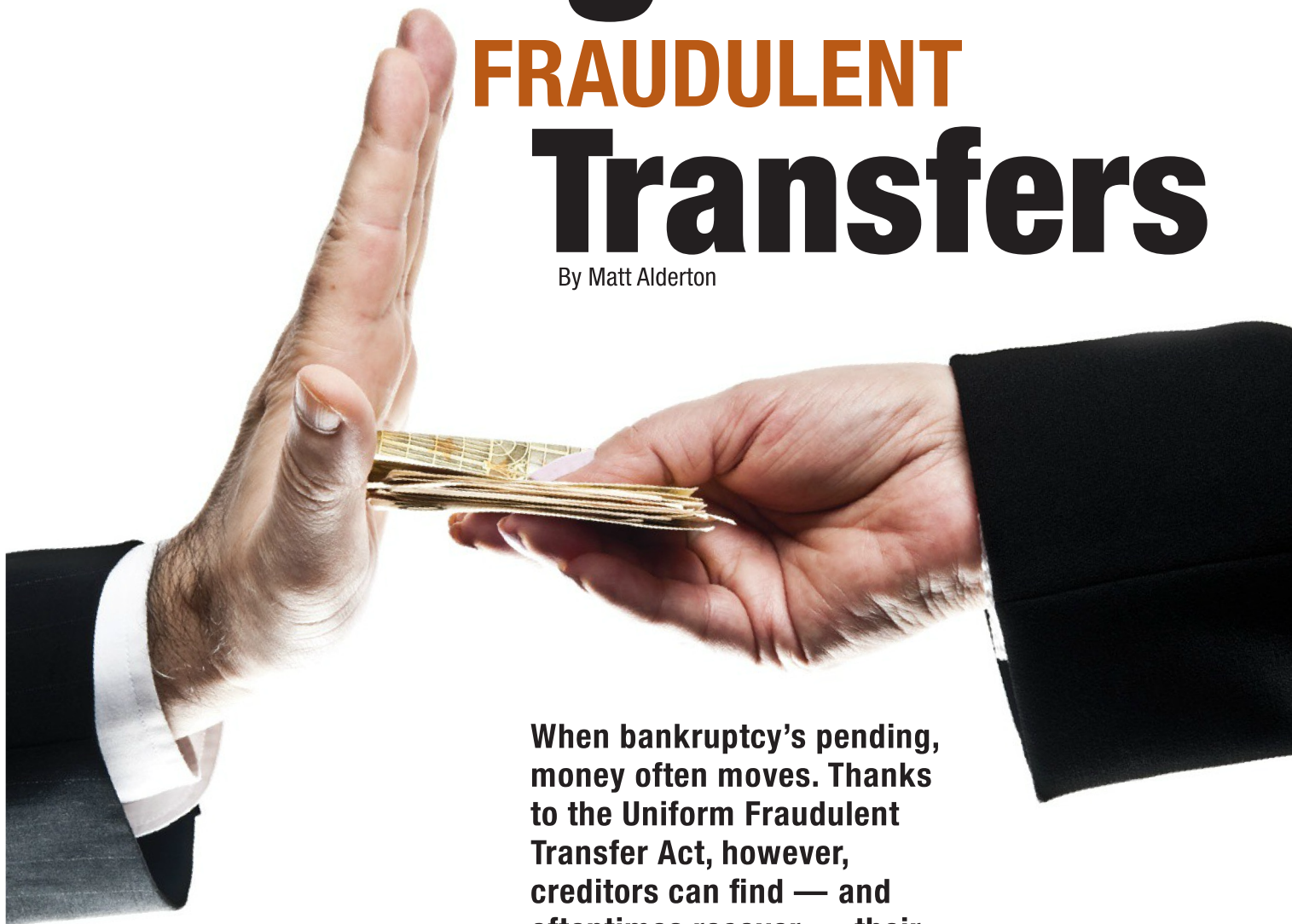

Foiling

FRAUDULENT

Transfers

By Matt Alderton



When bankruptcy's pending, money often moves. Thanks to the Uniform Fraudulent Transfer Act, however, creditors can find — and oftentimes recover — their losses, even when the debtor is judgment proof.

On June 29, 2009, a federal judge sentenced Bernard “Bernie” Madoff to the maximum 150 years in prison for what has since been described as the largest Ponzi scheme in history. For Madoff, who pleaded guilty to 11 felonies, the trial was over. For the courts, however, the legal battle had only just begun.

Although Madoff was accused of defrauding investors of \$65 billion, only \$1.25 billion was initially recovered by liquidating his assets. Since then, court-appointed trustee Irving Picard has filed more than 1,000 lawsuits seeking more than \$100 billion in damages on behalf of defrauded investors. So far, he’s claimed just \$10 billion, or less than 10 percent.

To find the other 90 percent, Picard is looking for the rest of Madoff’s \$65 billion nest egg, which is believed to be residing with his family, friends and associates, including his wife, Ruth, whose assets totaled \$92.6 million at the time of her husband’s arrest, according to a 2009 court filing, which cites among the assets in her name a \$7 million penthouse on New York’s Upper East Side that was later seized and sold, an \$11 million mansion in Florida, \$8.8 million in yachts, \$2.6 million worth of jewelry and \$17 million in cash.

The initial fraud isn’t the only issue, therefore. In the Madoff case and countless others like it, the fraudulent transfer of money for the purpose of protecting it is an equally vexing predicament.

“When you’re thinking about fraudulent transfers, think about Madoff’s wife or Madoff’s children,” says David Wall, director of forensics at EP Forensic & Valuation Services LLP in Ontario, Calif. “This is about a bad guy, or a debtor, who you can’t get your money from, but who has made transfers to family members, business associates and insiders. The law can’t tolerate that.”

Neither can creditors, who have the law on their side thanks to the Uniform Fraudulent Transfer Act (UFTA), which can help bankruptcy attorneys and credit agencies reclaim their clients’ losses from deadbeat debtors.

Hiding Assets Via a Fraudulent Transfer

A fraudulent transfer, or fraudulent conveyance, occurs when a debtor who is insolvent or about to become insolvent transfers assets to an insider for the purpose of hiding them, which technically leaves him

or her with nothing to pay creditors and therefore renders the debtor judgment proof.

“A company can pay money out to anybody for any reason at all if they’re solvent,” explains William K. Lenhart, partner in the New York office of BDO Consulting, where he also is national director of the firm’s Business Restructuring practice and president of BDO Consulting Corporate Advisors, its corporate restructuring consultancy. “But if that transaction is done when they’re insolvent, or if it renders them insolvent, then it’s a potential fraudulent conveyance where creditors can call back that money or asset.”

Fraudulent transfers are addressed in the federal Bankruptcy Code, as well as in the UFTA, which was last updated in 1979 and establishes two types of fraud:

1. Actual fraud: Transfers are actually fraudulent when they’re made with “actual intent to hinder, delay or defraud” a creditor.

2. Constructive fraud: Transfers are constructively fraudulent when they make the debtor insolvent — or are made when the debtor already is insolvent — and when insolvency is concurrent with or following “failure to receive adequate consideration,” which requires an exchange of “reasonably equivalent value.”

According to Wall, the UFTA dates back to 16th-Century England.

“It’s in the Statute of 13 Elizabeth in 1570,” he says. “That statute basically said, ‘Hey, if you owe people money, you can’t be making transfers to defeat the claims.’ I don’t know what the statute was about — it probably had to do with some farmer who moved his goats to his brother’s property — but it’s been part of English common law ever since.

“In fact, it’s referred to in some of the works of Shakespeare: The original actor who played Hamlet in its first run became the subject of a fraudulent transfer action,” Wall says. “He was one of the owners of the Globe Theatre, and he had creditors after him, so he picked up the Globe Theatre timber by timber and moved it to a new location across the Thames River in a different municipality to defeat the creditor’s claims.”

Troublesome Transfers

Although it’s unlikely a debtor could get away with

physically moving the Globe Theatre in 2011, court dockets are filled with contemporary examples of fraudulent transfers.

The Madoff model — an individual protects assets by transferring them to someone else — is perhaps the simplest and most common scenario. However, there are others.

“Let’s say insiders or shareholders see that their company isn’t doing well, so they borrow money, then they use that money to pay themselves dividends,” Lenhart says. “Those dividends go to them personally, which means the money’s out of the estate. So, now the company is saddled with debt, but it doesn’t have any value to show for it. That’s a simple example where insiders took advantage of creditors by taking value out of the estate.”

A slightly more complicated case involves a spin-off. “Let’s say you have an oil company that’s also a manufacturer of some type,” Lenhart continues. “First they’re just one company, but then the shareholders decide, ‘We have a really profitable oil entity, but our manufacturing entity is going to be sued; why don’t we split the company in two?’ So, they create an oil company and a manufacturing company that’s a separate subsidiary, and over time they spin them off. That’s a type of fraudulent conveyance because it’s a way of screwing the creditors of the original joint entity.”

Bankruptcy litigator Joseph A. Marino, managing member at Marino, Mayers & Jarrach LLC in Clifton, N.J., offers yet another example.

“In a classic fraudulent transfer scheme, you have a creditor seeking to collect money from a debtor,” he explains. “When the attorney proceeds to execute, he finds that the debtor is out of business. Low and behold, a couple months later the client calls the attorney and says Bob Smith who ran ABC Furniture is still

operating at the same location, but instead of ABC Furniture it’s XYZ Furniture.”

The name may be different — but little else is.

“You find out that the guy basically closed the door and changed the sign and continued operation with a new corporation,” Marino says. “The successor entity is merely a change of hats, and therefore, the liability still attaches.”

Strategies for Success

Whatever the scenario, there are several strategies attorneys can use to successfully void fraudulent transfers.

Step one is identifying the people and entities involved. In the case of corporate debtors, that’s often very easy. “With fraudulent transfers, usually somebody who was involved in the old entity is now involved in the new entity,” Marino says. “Often you’ll see that Mr. Smith and Mr. Jones were partners; in the old entity, Mr. Smith was president and Mr. Jones was treasurer, but in the new entity, Mr. Jones is president and Mr. Smith is treasurer. If the new entity has the same address, the same people and the same phone number — especially the same phone number, because your customer base knows it, which is an asset — that’s a sign of fraudulent transfer.”

While scrutinizing the details can help you locate evidence, attorneys typically must look beyond debtors to reclaim losses. “The person who beats you in the first place typically is judgment proof; he’s somebody you can’t do business with,” Wall says. “The concept of the UFTA is that there are people surrounding the bad guy who get involved in these things. They don’t always understand what they’re getting into, and they usually don’t want to be in the middle of it. So, when

you put them in the middle of it, that’s when the bad guy comes back to the table.”

Wall recalls the case of a couple he calls David and Carol Smith, who owed his client money. The Smiths withdrew approximately \$124,000 in the form of two cashier’s checks, which they sat on for approximately six months, making

For more on the Uniform Fraudulent Transfers Act,

visit <http://www.youtube.com/user/MyCLLA> to view CLLA

Executive Vice President Oliver Yandle’s discussion with David

Wall -- director at EP Forensic Services -- and upcoming speaker at the **CLLA Nov. 10-12 Fall Meeting in New York** -- about the challenges attorneys face in fraudulent transfer cases.

it appear as though the money had vanished. When the checks were about to expire, the Smiths deposited them into another account that belonged to a woman Wall calls Michelle Johnson, who later turned out to be David and Carol's youngest daughter.

Upon discovering this, Wall filed a lawsuit against Johnson for the amount of the cashier's checks, leaving her vulnerable to asset seizures, wage garnishments, liens, etc.

"Nobody wants to do that to their baby daughter," Wall says. "When we started going after her, that was the end. It was a full and complete capitulation on everything. That's the overall strategy: Isolate the weakest link and apply the maximum amount of pressure to that spot until they capitulate."

In the case of corporate debtors, Lenhart says, the weakest link might be neither the transferor nor the transferee, but rather a third party, such as an insurance company, if the debtor has director and officer insurance, or a lender — a bank, for instance, or a private equity firm — that took actions that harmed creditors.

Whoever you pursue and however you pursue them, you ultimately must prove either actual fraud (i.e., intent) or constructive fraud (i.e., insolvency and lack of consideration), both of which can benefit from the services of a forensic accountant. "The only way you can get any money is to look at transactions to see if any are actionable," Lenhart says. "You really need to do both a legal and financial review."

And remember: The UFTA is but one tool of many. "If a fraudulent transfer action isn't enough to impress people — maybe they've hired a good attorney who's fighting back — maybe you need to do a little more work," Wall says, recalling another claim against David and Carol Smith.

What States Say

The Uniform Fraudulent Transfer Act (UFTA) is part of the codified law in 43 states and the District of Columbia, and common law in at least 49 of the 50 states — except Louisiana, which has its own unique statutes — according to David Wall, director of forensics at EP Forensic & Valuation Services LLP.

For the most part, it's identical coast to coast. However, there are a few key differences worth noting:

- **Statute of Limitations.** Perhaps the biggest state-to-state difference in fraudulent transfer law is the statute of limitations. Some states allow you to look at transactions as far back as six years, says William K. Lenhart, partner at BDO Consulting.
- **Community Property Considerations.** Some states, such as California, are community property states, according to Wall, which means that fraudulent transfer law in those states often intersects with family and marital law.
- **Laws That Favor Creditors — Or Debtors.** To some extent, fraudulent transfer laws track states' bankruptcy laws, Wall says. For instance, bankruptcy laws in Texas and Florida tend to be more debtor-friendly while those in California and New York typically are more creditor-friendly.
- **Determining Insolvency.** Although all fraudulent transfer laws require creditors to prove insolvency and lack of consideration, the definitions of each can vary slightly from state to state, according to Lenhart. With regard to insolvency, for instance, some states rely on the "balance sheet" test — a simple "debts vs. assets" test — while others rely on the "cash flow" test, which examines a debtor's ability to pay debts when they come due.

"David and Carol made a separate transfer to some other people. We sued those people under the Racketeer Influenced and Corrupt Organizations (RICO) Act. I don't care who you are; unless you're a hardcore crook, you don't want an armed sheriff coming to your door at dusk in front of your neighbors with a piece of officially stamped paperwork accusing you of violating RICO."

The move was an effective one. "We charged them with conspiracy, as well," Wall says. "So, another strategy is to take your fraudulent transfer claims and wrap them up in a nice piece of wrapping [paper] with a bow on it. If you jack the stakes up a little bit, that will get their attention." ●