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Delaware Court "Champions" *Per Se* Rule for Constructive Fraudulent Transfers

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In *In re Champion Enterprises Inc.*, the U.S. Bankruptcy Court for the District of Delaware dismissed, *inter alia*, portions of the creditors' committee's complaint against the pre-petition lenders that alleged that transfers of certain cash, collateral and other rights were constructive fraudulent transfers.[2] In doing so, Hon. **Kevin Gross** applied a "*per se* test": A payment made or collateral granted on account of valid third-party antecedent debt, while potentially preferential, is *per se* not a fraudulent transfer.


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The *Champion* court appears to be one of the only courts outside the Southern District of New York to have applied this test. Such courts (including another ruling from a bankruptcy court in the District of Delaware)[3] have generally preferred a more flexible "facts and circumstances" test. Mitigating this break from precedent, however, is the fact that the *Champion* court was analyzing a New York statute (premised on the Uniform Fraudulent Conveyance Act) applicable pursuant to § 544(b) of the Bankruptcy Code rather than the Code's own fraudulent-transfer provisions in § 548.

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The Champion *Decision*

Champion was an international manufacturer of factory-constructed housing and modular buildings. As the company's operating conditions began to deteriorate, it entered into a series of forbearance agreements with the lenders under its secured lending facility. Certain forbearance agreements improved the lenders' collateral positions and resulted in cash payments to the lenders from the issuance of additional debt.

News at 11

After Champion filed for chapter 11 protection, its creditors' committee brought an adversary proceeding alleging, *inter alia*, that the pre-petition transfers to the lenders pursuant to the forbearance agreements constituted constructive fraudulent transfers under § 544(b) and New York state law. The applicable New York fraudulent-conveyance statute states that any conveyance "made without fair consideration when the person making it is engaged or is about to engage in a business or transaction for which the property remaining in his hands after the conveyance is an unreasonably small capital" is fraudulent as to the other creditors of the debtor, and that "fair consideration" is given when (1) in "good faith" and as "a fair equivalent" property is conveyed *or an antecedent debt is satisfied in exchange*, or (2) property is "received in good faith to *secure a present advance or antecedent debt in amount not disproportionately small*."[4]


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The creditors' committee alleged that there was no fair consideration for the payments and security interests given to the lenders under the forbearance agreement, but importantly, did not allege that the underlying debt was avoidable. Simply stated, the lenders' response was that the repayment of—or security for—their outstanding indebtedness statutorily constituted fair consideration. The court agreed, holding that the "security interests granted by Champion in respect of an antecedent debt, like repayment of antecedent debt... are necessarily fair consideration" under the New York statute.[5]

The Per Se *Test*

Champion closely follows the precedent decisions in the Southern District of New York, applying the same *per se* test, which is understandable as the *Champion* court was interpreting a New York statute. Courts in the Southern District of New York also apply the same *per se* test to fraudulent-transfer claims under § 548. Under § 548, a debtor in possession (DIP) may avoid any transfer for which the debtor receives less than

1 The authors thank Brandon Smith for his assistance in the preparation of this article.
2 *In re Champion Enters. Inc. (Official Comm. of Unsecured Creditors of Champion Enters. v. Credit Suisse)*, 2010 Bankr. LEXIS 2720 (Bankr. D. Del. Sept. 1, 2010).
3 *See In re Exide Technologies Inc. (Official Committee of Unsecured Creditors v. Credit Suisse First Boston)*, 299 B.R. 732, 748 (Bankr. D. Del. 2003).
4 *N.Y. Debt. & Cred. Law* § 272, 274 (2010) (emphasis added).
5 *Champion Enters.*, 2010 Bankr. LEXIS 2720 at *61 (citing *In re AppliedTheory Corp. (Geron v. Palladin Overseas Fund Ltd.)*, 323 B.R. 838, 841-44 (Bankr. S.D.N.Y. 2005) ("*AppliedTheory I*"), *aff'd*, 330 B.R. 362 (S.D.N.Y. 2005) ("*AppliedTheory II*").

reasonably equivalent value at a time when the debtor was insolvent or left with unreasonably small capital. The New York courts have found that the "reasonably equivalent value" test in § 548 is interchangeable with the "fair consideration" test in the New York statute—despite the fact that good faith is a component of the fair-consideration test under New York law but does not appear in § 548.[6]

When analyzing a potential fraudulent transfer to pre-petition lenders, the *per se* test provides that a debtor's repayment or "grant of a security interest in its assets to a lender who has previously given the debtor a cash loan may not be considered a fraudulent conveyance."[7] The *per se* test has intuitive appeal: Repayment of legitimate debt, and the corresponding reduction thereof, nearly tautologically provide reasonably equivalent value for the repayment. In other words, "[p]ast consideration is good consideration."[8] Moreover, if actual repayment—cash literally out the door for the debtor—is not a fraudulent transfer, then *a fortiori,* the grant of a security interest to secure valid antecedent debt, is not a fraudulent transfer since a creditor can only recover from such collateral up to the amount of its debt.[9] However, one could question whether a *per se* test should apply where the New York statute requires a determination that the transfer was made in good faith.

Courts following the *per se* test have stated that the correct remedy, if any, for payments made or collateral granted on account of antecedent debt is not a fraudulent-transfer action but rather a preference action under § 547 of the Code. The fact patterns of these cases have many of the hallmarks of a preference action, which allows a DIP to recover certain transfers "for or on account of antecedent debt" made when the debtor was insolvent.[10] However, preference actions against non-insiders have only a 90-day look-back period from the petition date, whereas fraudulent-transfer actions have look-back periods of two years under § 548 and six years under the applicable New York statute. In addition, preferences are subject to certain defenses not applicable to fraudulent transfers, such as the ordinary-course-of-business defense.

Exceptions to the Per Se Test

There are a few subtleties and one exception to the *per se* test worth mentioning. Some courts have indicated that it is both the antecedent debt and a contemporaneous forbearance by the lenders that act as reasonably equivalent value for the grant of collateral.[11] While courts have held that valid antecedent debt alone is sufficiently fair consideration, grants of collateral to a creditor without a corresponding forbearance from such creditor might have a somewhat higher fraudulent-transfer risk even under the *per se* test.

Additionally, one leading decision in the Southern District of New York expressly limited its application of the *per se* test to "money actually borrowed and received."[12] The court left open whether it would apply the *per se* test if the antecedent debt was a "mere guaranty."[13] Moreover, at the risk of pointing out the obvious, antecedent debt likely is only a fair equivalent for transfers received to the extent that such debt is a valid obligation of the debtor. To the extent that the underlying debt is avoidable by the debtor or other creditors, any transfers on account thereof are also at risk of avoidance.

One rather significant exception to the *per se* test developed by New York courts hinges on the requirement in the applicable New York statute that transfers be conveyed in "good faith."[14] New York courts have developed a rule that "transfers from an insolvent corporation to an officer, director or major shareholder of that corporation" are necessarily not made in "good faith."[15] This rule has been used by courts to find that the repayment of antecedent debt to an insider was a fraudulent transfer irrespective of the validity of the debt.[16] In *Champion*, the court noted this exception under New York law but found the pre-petition lenders not to be insiders (despite arguments to the contrary).[17]

An interesting observation about this line of cases is that New York courts avoid debt repayments made by insolvent debtors to insiders without inquiring as to the presence of any of the customary facts or circumstances typically required to recharacterize the insider's debt as equity or equitably subordinate the insider's claims under the Code.[18] This rule seems likely to discourage insiders from providing rescue financing to distressed debtors at a time of great need and fails to recognize that some insider loans have the hallmarks of legitimate debt obligations (rather than equity-like characteristics) and are made with the purest of intentions. Other states, such as Delaware, have addressed this policy concern by providing a statutory safe harbor for insider transfers that are good-faith efforts to rehabilitate an insolvent debtor.[19]

Facts-and-Circumstances Test

While not universal, most courts outside the Southern District of New York have declined to adopt the *per se* test for analyzing allegedly fraudulent transfers to pre-petition lenders under § 548.[20] These courts instead apply a flexible "facts and circumstances" test. In the prior Delaware case on this topic, *In re Exide Technologies Inc.*, Hon. **Mary Walrath** explained the test as looking at the "totality of the circumstances" and "determining whether a transaction conferred reasonable commercial value [that was] reasonably equivalent value to the realizable commercial value of the assets transferred."[21] The factors considered range from "the good faith of the parties, the difference between the amount paid

6 *See AppliedTheory I* at 840-84 (citing *In re Trace Int'l Holdings Inc. (Pereira v. Dow Chem. Co.)*, 301 B.R. 801, 805-6 (Bankr. S.D.N.Y. 2003), *vacated on other grounds*, 2009 U.S. Dist. Lexis 55168 (S.D.N.Y. June 25, 2009)).

7 *AppliedTheory II* at 363. *See also In re M. Silverman Laces Inc. (Cuevas v. Hudson United Bank)*, 2002 U.S. Dist. LEXIS 20288, at *15 (S.D.N.Y. Oct. 23, 2002) (affirming bankruptcy court's conclusion that debtor received reasonably equivalent value as matter of law in exchange for grant of security interest in inventory); *In re M. Fabrikant & Sons Inc. (Official Committee of Unsecured Creditors v. JPMorgan Chase Bank NA)*, 394 B.R. 721, 732 (Bankr. S.D.N.Y. 2008) ("A valid antecedent debt provides adequate consideration to support the grant of a security interest."); *In re MarketXT Holdings Corp. (Nisselson v. Softbank AM Corp.)*, 361 B.R. 369, 398 (Bankr. S.D.N.Y. 2007) ("The cases are uniform that the grant of collateral for a legitimate antecedent debt is not, without more, a constructive fraudulent conveyance.").

8 *Trace Int'l Holdings Inc.*, 301 B.R. at 805.

9 *Cf. AppliedTheory II* at 363 ("[T]he *per se* rule consistently applied in this District...provides that a debtor's grant of a security interest in its assets to a lender who has previously given the debtor a cash loan may not be considered a fraudulent conveyance.").

10 11 U.S.C. § 547(a).

11 *See MarketXT Holdings*, 361 B.R. at 398-99 ("the federal cases hold that a grant of collateral *together with forbearance* constitutes reasonably equivalent value" (emphasis added)).

12 *AppliedTheory I* at 844.

13 *Id.; see also Stillwater Nat'l Bank and Trust Co. v. Kirtley (In re Solomon)*, 299 B.R. 626 (10th Cir. B.A.P. 2003) (questioning "the soundness of applying the *per se* rule in those cases where the debtor received no loan proceeds from the antecedent debt and only provides the security for a third party's antecedent debt").

14 *N.Y. Debt. & Cred. Law* § 272 (2010).

15 *See, e.g., In re Le Cafe Creme Ltd. (Le Cafe Creme Ltd. v. Le Roux)*, 244 B.R. 221, 241 (Bankr. S.D.N.Y. 2000) (citing *Atlanta Shipping Corp. v. Chemical Bank*, 818 F.2d 240, 249 (2d Cir. 1987).

16 *See In re Sharp Int'l Corp. (Sharp Int'l Corp. v. State St. Bank & Trust Co.)*, 403 F.3d 43, 54 (2d Cir. 2005) ("One exception has been recognized by the New York courts to the rule that the repayment of an antecedent debt constitutes fair consideration: where the transferee is an officer, director, or major shareholder of the transferor."); *HBE Leasing Corp. v. Frank*, 48 F.3d 623, 634 (2d Cir. 1995) ("New York courts have carved out one exception to the rule that preferential payments of pre-existing obligations are not fraudulent conveyances: preferences to a debtor corporation's shareholders, officers or directors are deemed not to be transfers for fair consideration.").

17 *Champion Enters.*, 2010 Bankr. LEXIS 2720 at *17-*24 and *56 (finding lenders not to be nonstatutory insiders under test recently established by Third Circuit in *In re Winstar Communications Inc. (Schubert v. Lucent Techs. Inc.)*, 554 F.3d 382, 395 (3d Cir. 2009)).

18 This rule would seemingly apply to the collateralization of antecedent debt as well as the repayment of antecedent debt, though the authors are not aware of any cases where this was at issue.

19 *See* 6 Del. C. § 1308(f).

20 *See, e.g., Exide Techs.*, 299 B.R. at 748; *Anand v. National Republic Bank of Chicago*, 239 B.R .511, 518 (N.D. Ill. 1999); and *In re Solomon (Stillwater Nat'l Bank & Trust Co. v. Kirtley)*, 299 B.R. 626, 636 (10th Cir. B.A.P. 2003); *but see In re Erie Marine Enterprises Inc. (Erie Marine Enterprises Inc. v. Nationsbank NA)*, 216 B.R. 529, 538 (Bankr. W.D. Pa. 1998).

21 *Exide Techs.*, 299 B.R. at 748 (internal quotations and citations omitted).

and the fair market value, and whether the transaction was at arms' length."[22] Other courts have looked "to the other value, beyond the loan, that the debtor received in conjunction with the transfer."[23] In other words, the existence of the antecedent debt, standing alone, is not necessarily reasonably equivalent value.

When the transfer at issue is a security interest in the debtor's assets as opposed to repayment of the antecedent debt, at least one court applying the facts-and-circumstances test has weighed the disparity between the debt amount and the collateral value.[24] Courts in the Southern District of New York applying the *per se* test have explicitly declined to consider such disparity.[25] This is in spite of the plain language of the New York statute, which states that fair consideration is given when "such property...is received in good faith to secure...antecedent debt in amount *not disproportionately small as compared with the value of the property*."[26]

Conclusion

While the facts-and-circumstances test necessarily increases the uncertainty around fraudulent-transfer risk *vis-à-vis* the *per se* test, in practice the two tests have not led to dissimilar results. For example, an important factor in the application of the facts-and-circumstances test is whether there was a contemporaneous forbearance or other covenant easing on the part of the pre-petition lenders, and, as noted, some courts have hinted that the combination of a forbearance and the existence of the antecedent debt is what the *per se* test requires. In addition, instances where courts have found repayment of antecedent debt or grants of security interests to pre-petition lenders to be fraudulent conveyances under the facts-and-circumstances test tend to be those either where the validity of the underlying debt is questioned by the court[27] or where the debtor did not receive any direct benefit on account of the debt but was a mere guarantor.[28] Courts applying the *per se* test have implied that a pre-petition creditor in these circumstances might also be at risk for a fraudulent-transfer claim.[29]

It would have been interesting to see whether the *Champion* court would have applied a *per se* test to a claim under § 548. The court does appear to be the only court outside the Southern District of New York to apply the *per se* test, but its analysis was under a New York statute, and New York precedent interpreting that statute applied the *per se* test. The *Champion* court may have followed the prior decision in its district (*Exide Technologies*) and applied the facts-and-circumstances test if it was analyzing the transfer under § 548, but in all probability it would have reached the same conclusion that the transfers at issue were not constructively fraudulent. ■

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22 *Id.*

23 *Anand*, 239 B.R. at 518; *but see In re GTI Capital Holdings, LLC (Reaves v. Comerica Bank-California)*, 373 B.R. 671, 678 (Bankr. D. Ariz. 2007) ("A debtor can receive reasonably equivalent value for the securing of an antecedent debt without receiving any 'new value.'").

24 *In re Countdown of Connecticut Inc. (Ris v. Society for Savings)*, 115 B.R. 18, 21-22 (Bankr. D. Conn. 1990).

25 *See AppliedTheory I* at 842 ("[T]he value of collateral [is] not relevant in determining whether the debtor received reasonably equivalent value in exchange for its granting the security interest, because the rights of a secured creditor in collateral are always restricted by the amount of the debt.").

26 *N.Y. Debt. & Cred. Law* § 274 (2010) (emphasis added).

27 *See In re Broumas (Koch v. Rogers)*, 203 B.R. 385, 389 (D. Md. 1996), *aff'd in part, rev'd in part*, 1998 U.S. App. LEXIS 3070 (4th Cir. Feb. 24, 998).

28 *In re Solomon (Stillwater Nat'l Bank & Trust Co. v. Kirtley)*, 299 B.R. 626, 628 (10th Cir. B.A.P. 2003).

29 *See AppliedTheory I* at 844 (declining to reach question of whether *per se* test is valid for "mere guaranty").