Small Business Notes

Can a Debtor Avoid Payment by Declaring Bankruptcy?

By Peter Janovsky, Partner, Zeichner Ellman & Krause LLP

Consider the following scenario:

Al owes his former partner, Sam, $2 million. Sam lent him the money when they started a business together. Sam commences a lawsuit against Al to recover the money, and Al says, "You're wasting your time. I'm judgment proof." (That is, even if a judgment is obtained, Sam won't be able to collect anything because Al has no assets.)

Sam reminds Al that he lives in a multi-million-dollar home, owns a Chris Craft boat and has a summer home in East Hampton. "Oh those," Al laughs. "The wife owns all of that."

Is Sam out of luck? Maybe not. Depending on a series of factors, the transfer of properties into a wife's (or someone else's) name may be reversed and the property used to satisfy a judgment. The plaintiff, Sam, may not have to prove that the transfer was intentionally made to avoid paying Sam. Below are six important points for a banker or a small businessperson to know about recovering funds that have been transferred to avoid creditors.

1. "Consideration":
   Consideration is the heart of the matter. This is what one gets in return for something they've given. The law dislikes someone getting something for nothing if it harms others. If a debtor gives the house to his wife, relative or anyone else without payment, the gift may be a fraudulent transfer if certain criteria discussed below are met.

2. "Intentional" vs. "Constructive Fraud":
   To reverse a fraudulent transfer, you don't necessarily have to prove that the transferor intended to give away his property to evade his creditors. You can also win on "constructive" fraud, by showing the existence of certain other conditions at the time of a no-consideration transfer. For example, constructive fraud can be shown if, at the time of a transfer, a debtor was insolvent, was rendered insolvent by the transfer, or was a defendant in a lawsuit at the time of the transfer. But even when you are seeking to prove "intentional" fraud, you don't necessarily have to have "smoking gun" evidence that a transfer was intentional. You can prove intentional fraud through showing certain "badges of fraud."

3. "Badges of Fraud:"
   Courts have found certain factors to be "badges of fraud," from which a court can infer intent to make a fraudulent transfer:

   a. lack or inadequacy of consideration;

   b. family, friendship or close associate relationship between the parties;

c. whether the transferor retains possession, benefit or use of the property;

d. the financial condition of the transferor before and after the transfer;

e. how the transfer fits into a pattern of transactions at a time of financial difficulties or threats of legal action against the transferor; and/or

f. the general chronology of the events.

Not all of the above are needed to prove an intentional transfer.

4. Proving Insolvency:
As mentioned, even if a no-consideration transfer can't be shown to be intentional, it can still be reversed if the transferor was insolvent at the time of transfer, or was rendered insolvent by the transfer. Insolvency will likely involve analysis of the borrower's financial statements or other financial data. Most states also provide other grounds for reversal of a transfer even if insolvency cannot be proven. For example, a transfer may be avoided if it is made without consideration after a lawsuit is commenced by a creditor.

5. Foreign Asset Protection Trusts:
Some debtors have transferred some or all of their assets into "asset protection trusts," in foreign jurisdictions ("FAPTs"). However, there is a recent trend toward permitting attacks on these trusts based on fraudulent transfer law. Some courts have even jailed trust settlors for contempt for refusing to repatriate FAPT assets. In addition, the 2005 Amendments to the Federal Bankruptcy Code have strictly limited this tactic by providing for a 10-year "clawback," mandating return of funds transferred to such trusts with the intent to hinder, delay or defraud creditors.

6. Investigators and the Internet:
Asset searchers today have many more tools than in the past to discover transfers of property. The click of a computer mouse can often track down suspect transfers. Investigators combine use of both the internet and more traditional methods to discover possible fraudulent transfers.

Based on the factors above, Sam may be able to satisfy a money judgment against Al if, for example, Al gave his wife his assets for nothing at a time when he was insolvent, or became insolvent as a result. Al may find that uncovering "badges of fraud" can be a fruitful way to find unexpected sources for his satisfying unpaid debt.

Peter Janovsky is an attorney in New York specializing in the representation of financial institutions and individual clients in commercial litigation and bankruptcy matters. He is a partner at Zeichner Ellman & Krause LLP, a 35-lawyer firm whose clients include both large and small banks, business corporations, as well as individuals. Mr. Janovsky is a graduate of Columbia University and the Fordham University School of Law.

For more information about fraudulent conveyances or other information about creditors' rights, contact Mr. Janovsky at Pjanovsky@zeklaw.com. For more information about Zeichner Ellman & Krause, visit the website: http://www.zeklaw.com/.