RECENT DEVELOPMENTS IN THE ANCIENT DOCTRINE OF FRAUDULENT CONVEYANCE: IT ALL STARTED WITH AN ENGLISHMAN'S SHEEP….

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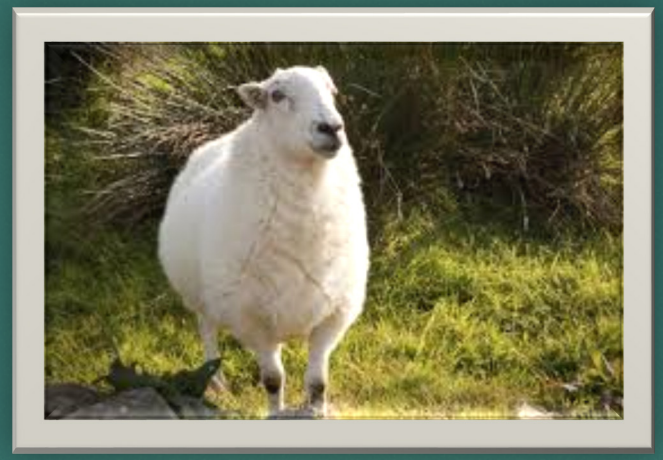
Jason S. Brookner
Gray Reed & McGraw, P.C.
Dallas, Texas
jbrookner@grayreed.com

Ronald R. Peterson
Jenner & Block
Chicago, Illinois
rpeterson@jenner.com

Fraudulent Conveyances Act 1571, Statute of 13 Elizabeth (13 Eliz 1, c 5)

- For the avoiding of feigned, covinous and fraudulent feeoffments, gifts, grants, alienations, bonds, suits, judgments and executions, as well of lands and in tenements, as of goods and chattels, more commonly used and practised in these days than hath been seen or heard of heretofore; which feoffments, gifts, grants etc have been and are devised and contrived of malice, fraud, covin, collusion or guile to the end, purpose and intent to delay, hinder or defraud creditors and others of their just and lawful actions, suits, debts, etc; not only to the let or hindrance of the due course and execution of law and justice, but also to the overthrow of all true and plain dealing, bargaining and chevisance between man and man, without the which no commonwealth or civil society can be maintained or continued.
- Be it therefore declared, ordained and enacted, that all and every feoffment, gift, grant, alienation, bargain and conveyance of lands, tenements, hereditaments, goods and chattels, or any of them, by writing or otherwise, and all and every bond, suit, judgment and execution at any time had or made to or for any intent or purpose before declared and expressed, shall be from henceforth deemed and taken, only as against that person or persons, his or their heirs, successors, executors, administrators and signs of every of them, whose actions, suits, debts, etc; by such guileful, covinous or fraudulent devices and practices, as is aforesaid, are, shall or might be in anywise disturbed, hindered, delayed or defrauded, to be clearly and utterly void, frustrate, and of none effect, any pretence, color feigned consideration, expressing of use or any other matter or thing to the contrary notwithstanding.
- Provided that this act or anything therein contained shall not extend to any estate or interest in land, tenements, hereditaments, leases, rents, commons, profits, goods or chattels, had, made, conveyed or assured, or hereafter to be had, made, conveyed or assured, which estate or interest is or shall be, upon good consideration and *bona fide,* lawfully conveyed or assured to any person or persons, or bodies politic or corporate, not having at the time of such conveyance or assurance to them made any manner of notice or knowledge of such covin, fraud or collusion as is aforesaid.

Bahhhhh.....



Twyne's Case, 76 Eng. Rep. 809 (Star Chamber 1601)

- Farmer Pierce owed Twyne £400, and also owed another creditor £200. This creditor brought an action to collect against Pierce.
- While the writ was pending, Pierce sold his sheep to Twyne to pay off that debt, but Pierce remained in possession of the sheep (including marking and shearing them).
- The other creditor tried to seize the sheep, but Twyne resisted, arguing that he was a *bona fide* purchaser for value.
- Star Chamber decides that this was a fraud under the Statute of Elizabeth

- 1st. That this gift had the signs and marks of fraud, because the gift is general, without exception of his apparel, or any thing of necessity; for it is commonly said, *quod dolus versatur in generalibus*.
- 2nd. The donor continued in possession, and used them as his own; and by reason thereof he traded and trafficked with others, and defrauded and deceived them.
- 3rd. It was made in secret, *et dona clandestina sunt semper suspiciosa*.
- 4th. It was made pending the writ.
- 5th. Here was a trust between the parties, for the donor possessed all, and used them as his proper goods, and fraud is always apparelled and clad with a trust, and a trust is the cover of fraud.
- 6th. The deed contains, that the gift was made honestly, truly, and bona fide: *et clausulæ inconsuet' semper inducunt suspicionem*.

Twyne's Factors in "today's English"

- 1. Was the transfer of substantially all of the debtor's assets
- 2. Was the transfer hidden
- 3. Did the transferor maintain possession
- 4. Did the transferor retain an interest or a string to get the property back
- 5. Was there adequate consideration
- 6. Has the debtor absconded
- 7. Was the transferor under immediate creditor pressure or before the transferor would incur substantial liability
- 8. Transferee was an insider, including a relative
- 9. The transfer was to prefer an insider over other creditors
- 10. The transferor transferred the assets to a lien creditor, including an assignee for the benefit of creditors, who sold the goods back to the transferor an insider or a nominee of the transferor.

How does a 400+ year old case about an Englishman attempting to hide his sheep apply today?

Modern Twyne's Factors

- 1. Was a crime involved ?
- 2. Did the transferor violate a regulatory scheme designed to protect a class of creditors?
- 3. Did the transferor issue inaccurate information or omit to disclose critical information?
- 4. Did the transferor do a data wipe?
- 5. Did the transferor consult with insolvency professionals about fraudulent transfer liability?
- 6. Did the transferor lack a compelling legitimate business justification?

In re Sentinel Mgmt. Group, Inc., 728 F.3d 660 (7th Cir. 2013)

- Debtor took money from futures commission merchants (FCMs) as a "safe place to put their excess capital, assuring solid short-term returns, but also ready access to the capital."
- FCM funds were supposed to be segregated under the Commodities Exchange Act and applicable regulations. This meant that at all times, a customer's account was supposed to hold assets equal to the amount Sentinel owed the customer, and that Sentinel would treat and deal with the assets as belonging to such customer.
- Sentinel started moving money and securities from segregated customer accounts into "main accounts" to secure its borrowings from BNY Mellon.
- Eventually, during the early phases of economic meltdown, Sentinel wound up with a segregation shortfall of $700 million, and filed for chapter 11 owing BNY Mellon approximately $300 million.
- Trustee sues BNY Mellon seeking to set aside its liens as preferences and fraudulent conveyances, and to equitably subordinate the bank's claims.
- District court dismisses the claims, finding insufficient evidence of actual intent to hinder, delay or defraud creditors, and finding that equitable subordination is not warranted.

In re Sentinel Mgmt. Group, Inc., 728 F.3d 660 (7th Cir. 2013) (continued)

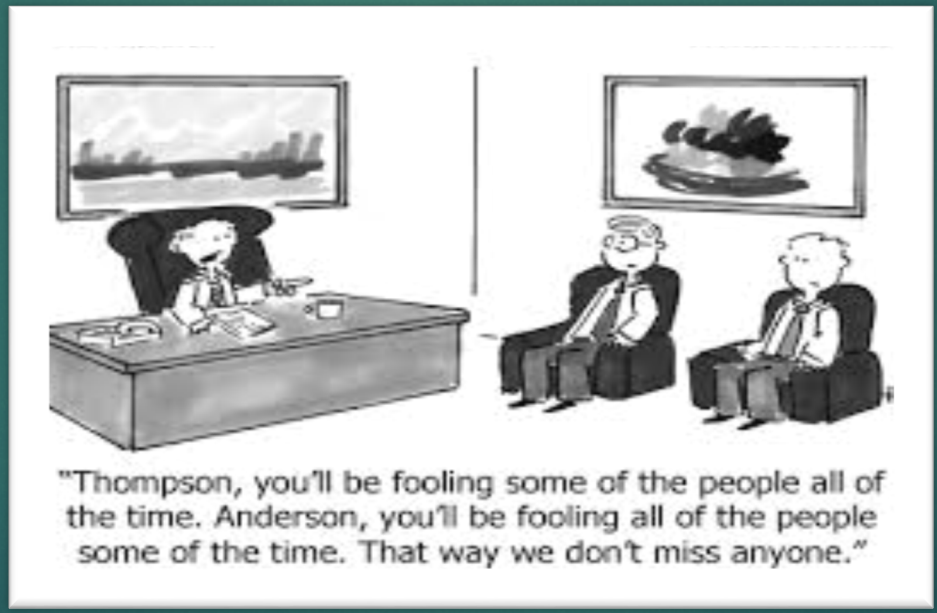
- On appeal, Seventh Circuit reverses.
- For fraudulent conveyance, the Court finds that a debtor can have intent to defraud without actually having the intent to defraud. Instead, even if a debtor has the best of intentions (like to just keep the doors open and really intend to pay creditors back later; REALLY!), there can still be a finding of actual intent if
  - the debtor did not have the intent to render the funds permanently unavailable to its FCMs, but should have seen this result as a natural consequence of its actions, and thus "knowingly exposed [FCMs] to a substantial risk of loss of which they were unaware", *Sentinel*, 728 F.2d at 667, 668; or
  - the debtor, *in an unlawful manner*, exposed its FCMs to a substantial risk of loss of which they were unaware. Thus even if Sentinel did not intend to harm its FCMs, Sentinel's intentions were hardly innocent because it knowingly violated the law by taking money out of segregated accounts, that were specifically required by statute to remain segregated. *Id*. at 668.
- For equitable subordination, the Court states that questions remain because the DCT's factual findings are contradictory. ***Be sure to attend the Brookner-Richman panel on equitable subordination where equitable subordination will be discussed in detail***.

Takeaway from *Sentinel and application to Twyne*

- Criminal Conduct
- Violation of governmental regulations enacted to protect certain constituencies
- Disinformation and lying

Ritchie Capital Mgmt. v. Stoebner, 2014 WL 1386724 (D. Minn. Jan. 6, 2014)

(aka Petters and Polaroid)



- Ritchie Capital Management and certain affiliated ("Ritchie") made multiple loans that were supposed to be short term, with an effective interest rate of 85% or higher. Eventually, the total amount loaned was approximately $189 million.
- The loans were made to Petters Group Worldwide ("PGW") and Tom Petters. The initial loan of approximately $31 million was originally made under the auspices of a $31mm loan from JP Morgan to Polaroid. All funds from all Ritchie loans were transferred to Petters Company, Inc. ("PCI"). PGW was the ultimate owner of Polaroid, and Polaroid was a stand-alone company that operated independent of the massive Ponzi scheme perpetrated and operated by Petters.
- When the loans were made in February 2008 and thereafter, they were unsecured, but were supposed to be secured by Petters' pledge of 100% of Polaroid's stock "as soon as reasonably practicable."
- Finally, in September 2008, immediately after the FBI raided Petters' home and business (which Petters shrugged off as no big deal), and after various extensions of credit by Ritchie, unfilled promises by Petters, defaults by Petters and much consternation, Ritchie was able to secure a pledge of Polaroid's trademarks in Brazil, India and China, as well as other associated property rights.
- Polaroid files for bankruptcy, and the trustee sues Ritchie to avoid its liens under theories of both actual and constructive fraudulent transfer.
- The Bankruptcy Court grants partial summary judgment in favor of the trustee on the issue of actual fraud, finding there to have been actual fraud under both "badges of fraud" and the Ponzi scheme presumption.

- District Court affirms on appeal
  - **Ponzi presumption**: *where the circumstance surrounding the transfer is a Ponzi scheme, courts have found that the existence of the Ponzi scheme satisfies the requirement of actual intent, because transfers made in the course of a Ponzi scheme could have been made for* ***no other purpose than*** *to hinder, delay or defraud creditors*.
  - Ponzi presumption has been adopted by the Fifth, Ninth, Tenth and Eleventh Circuits. *See, e.g.*, *Wing* v. *Dockstader*, 482 Fed. App'x 361, 363 (10th Cir. 2012); *Perkins v. Haines*, 661 F.3d 623,626-27 (11th Cir. 2011); *Donell* v. *Kowell*, 533 F.3d 762, 770-71 (9th Cir. 2008); and *Warfield v. Bryon*, 436 F.3d 551, 558-59 (5th Cir. 2006).
  - Ritchie argues that the presumption should not apply because it should be limited to where the debtor-transferor ***itself*** runs a Ponzi scheme and here, no one disputes that Polaroid was a legit business and ***not*** part of the scheme (despite the fact that no one disputes Petters did indeed run a Ponzi scheme).
  - Ritchie's argument overruled, based on the facts of the case: Petters controlled Polaroid as its chairman and sole board member. Polaroid had no intent or desire to effect the transfer; the transfer was made over Polaroid's objection ***by Petters himself***, who – as sole board member and chairman – had the authority to grant the security interest over Polaroid's objection.
  - Polaroid was inextricably intertwined with the overall Ponzi scheme operated by Petters. Indeed, Polaroid was purchased by Petters entirely, or nearly entirely, with fruits of the Ponzi scheme. "Petters personal interests were entirely intertwined with the Ponzi scheme and the scheme's continuation. Petters considered himself indistinguishable from the primary entity through which the Ponzi scheme operating, stating 'I am PCI' " 2014 WL at *33
  - "the applicability of the presumption comes down to the controlling person's motivation for effecting the specific transfer by the non-purveyor, 'legitimate' business entity, when and as the transfer is made . . . . The automatic inference of fraudulent intent is made when the person in common control effects the transfer by the entity extrinsic to the Ponzi scheme, but in order further the scheme as it has been maintained through the central entity. Yes, the creditors hindered, delayed and defrauded by the transfer are not the direct victims of the Ponzi scheme in its operation . . . . Nonetheless, it is a readily-identifiable group: the creditors of the related entity that makes the transfer for the benefit of the purveyor-entity. The intent that is deemed via the inference is the intent to deprive those parties of the value of their legal recourse against the debtor with which they are in privity, *i.e.*, the transferor that gives up its own assets at the beck of the person in common control, to satisfy a creditor of the purveyor-entity that is not a creditor of the transferor-entity." 2014 WL at *29.
- Matter is now on appeal to the 8th Circuit, and argument occurred on October 7, 2014. NABT (via our very own Ron Peterson) filed an *amicus* brief in support of the existence of the Ponzi scheme presumption.

Relation back to *Twyne's Case* and Statute of Elizabeth

- A Ponzi scheme is always "actual fraud" and is always insolvent from inception – that is the nature of the thing. It would seem to be the archetypal "feigned, covinous and fraudulent [enterprise] . . . devised and contrived of malice, fraud, covin, collusion or guile to the . . . purpose and intent to delay, hinder or defraud creditors and others . . . to the overthrow of all true and plain dealing, bargaining and chevisance between man and man, without the which no commonwealth or civil society can be maintained or continued"
- Due to the nature of a Ponzi scheme, traditional "badges of fraud" are essentially irrelevant – hence, the Ponzi presumption. *Ritchie*, 2014 WL at * 33 (citing cases)

Tronox Inc. v. Kerr McGee Corp. (In re Tronox Inc.), 503 B,.R. 239 (Bankr. S.D.N.Y. 2013)

(yes, the Kerr McGee of Karen Silkwood fame)

- KMC is formed in 1929 as an o&g exploration company, and over time, acquires multiple businesses: uranium mining and milling; wood treating plants (using the chemical creosote); chemicals (ammonium perchlorate for use in rocket fuel); rare earth facilities (producing radioactive rhorium); and a titanium dioxide plant.
- KMC is – perhaps obviously – burdened with enormous legacy and environmental tort liabilities: it had over 2,700 environmental sites in 47 states, including several Superfund sites, had incurred more than $1 billion in response costs since 2000, and was spending more than $160 million annually on remediation efforts. At the time, it had settled 15,000 claims of creosote tort liability for $72 million and had another 9,450 pending claims.
- The investment bankers were telling the company that its stock was undervalued, because the chemical business and associated liabilities were suppressing the stock price. The E&P assets is where the value is, so they had to be freed from the chemical liabilities.
- In 2000, KMC hatches a plan to "restructure" the company, which spins out the E&P business (to "New Kerr McGee") and leaves behind the chemical business ***and*** the associated tort and environmental liabilities in the company that is renamed "Tronox".
- A series of 11 corporate transactions were approved by the Board in September 2002, effective as of December 31, 2002: all of the business lines owned by Old KMC were transferred out to New KMC, and the chemical business was left behind.
- These transfers were ***wholly controlled*** by KMC and there was no ***meaningful public disclosure*** of the transactions. (there was just a teeny tiny mention of it buried in the 12-31-2002 Form 10-K). Further, after the transfer of the E&P assets in 2002, KMC "continued to operate as a consolidated entity. Until it finally spun off the E&P assets, Kerr-McGee continued to pay its creditor and fund all of its operations (Including its legacy liability expenses) out of its central cash management system without regard to the ability of the subsidiaries to pay the expenses on their own." *Tronox*, 503 B.R. at 252.

- The split of the assets was actually not final until the 2005 execution of an Assignment, Assumption and Indemnity Agreement (backdated to 2002) and a Master Separation Agreement between KMC and Tronox (the terms of which were dictated by KMC).
- Tronox transferred to KMC all of the proceeds of its IPO (over $200 million) as well as almost all the proceeds of its bond offering (over $500 million)
- Then, KMC retained control over Tronox after the spinoff, until its equity holdings in Tronox were distributed out to its own shareholders in March 2006.
- At the end of the day, Tronox was left with $40 million in cash to operate the business. That's it….
- Tronox was left ***not only*** with the legacy tort and envt'l claims, but was also saddled with $442 million in pension obligations and $186 million in "other post-employment benefits" obligations.

Tronox Observations and "highlights"

- Collapse transaction. 503 B.R. at 268-71 (relates to statute of limitations)
- FDCPA as "applicable law" under section 544. 503 B.R at 272-75.
- USA as "triggering creditor". 503 B.R. at 275-76.
- Can have actual fraud even if no "intent to . . . Defraud." An intent to "hinder and delay" is enough : "Liability is imposed for an 'intentional fraudulent conveyance' where the fact and purpose of a conveyance may have been known to creditors in whole or in part, but the transferor intended to hinder or delay them." 503 B.R. at 278; *see also Shapiro v. Wilgus*, 207 U.S. 348, 354 (1932)("A conveyance is illegal if made with an intent to defraud the creditors of the grantor, but equally it is illegal if made with an intent to hinder or delay them")
  - The intent was to free substantially all assets from 85 years of envt'l liability. The obvious consequences of this act was that legacy creditors would have a minimal asset base from which to recover in the future. This was the intended consequence of the act, substantially certain to result from it. Creditors, were thus, "hindered or delayed." 503 B.R. at 280.
  - Split recognized regarding standard of proof for actual intent: preponderance or clear and convincing evidence? 503 B.R. at 282, n. 52. But, court finds that plaintiffs met the clear and convincing standard.
- Court finds 5 out of 11 UFTA badges of fraud to be present, and just one is enough to create a presumption defendant must rebut (503 B.R. at 283-284:
  - Transfer or obligation was to an insider: KMC's assets transferred to an affiliate
  - Debtor retained possession or control of the property after the transfer: KMC retained possession and then retained control even after the IPO – effectively controlled Tronox until the final spin in March 206
  - Transfer or obligation was disclosed or concealed: ineffective and insubstantial disclosure of transactions
  - Before the transfer or obligation, debtor had been sued or threatened with suit: KMC had been in envt'l and tort litigation for years
  - Transfer was substantially all of the debtor's assets: yes.

Tronox Observations and "highlights" (cont'd)

- To rebut presumption of intent to hinder and delay, under OK UFTA, defendant must show "a legitimate supervening purpose for the conveyances." Ummm, not so much….. 503 B.R. at 284-281.
- Constructive fraudulent conveyance (yes). 503 B.R. 291-324.
  - Less than reasonably equivalent value in exchange for the transfer. 503 B.R. at 295; and
  - Insolvent? Yes. (but because insolvency is based on the value of unliquidated claims, the extent of insolvency need not be calculated to the dollar. 503 B.R. at 319; or
  - Unreasonably small/inadequate capital? Yes. 503 B.R. at 323; or
  - Inability to pay debts as they become due? Yes. 503 B.R. at 324.

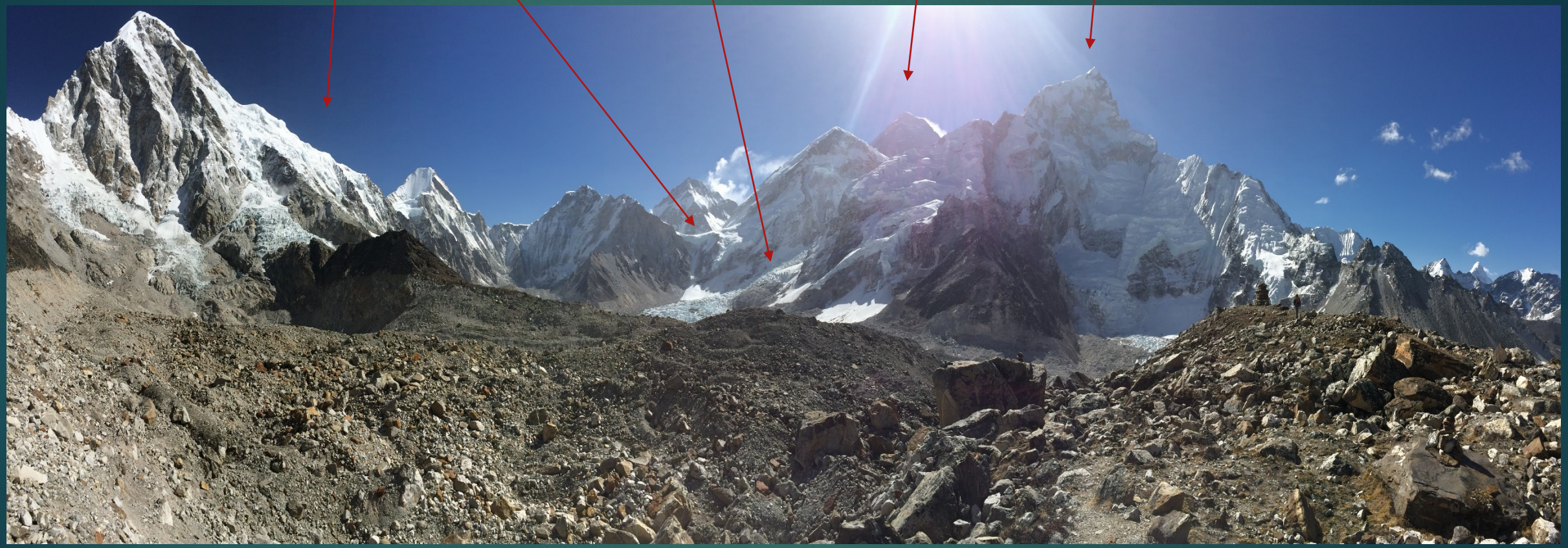
Application of "traditional" *Twyne's* factors to *Tronox*

- 1. Transfer was of substantially all of the debtor's assets (the valuable ones)
- 2. Transfer was hidden (*i.e.*, lack of disclosure)
- 3. Transferor maintained possession/control over the assets transferred (and maintained control over Tronox itself)
- 5. Lack of adequate consideration
- 8. Transferee was an insider

Application of Modern *Twyne's* Factors to *Tronox*

- 3. Transferor issued inaccurate information and omitted to disclose critical information
- 5. Transferor did not per se consult with insolvency professionals about fraudulent transfer liability, but notes about there being "bankruptcy implications" and "complexities" were admitted into evidence and discussed in the opinion.
- 6. Transferor lacked a compelling legitimate business justification for the transfers (or, per OK law, the transferor could not prove a "legitimate supervening purpose" for the transfer.

Sunrise over Mount Everest



 Taken from Kala Patar on the morning of April 29, 2014.