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BANKING UPDATE

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CAN A GUARANTY BE FRAUDULENT?

By Gladys Goschka

When you structure a loan supported by a guaranty, should you be thinking about fraudulent transfer concerns? The answer is most definitely yes. You do not want to be in a situation where the guaranty you thought you had is unenforceable, and, worse yet, the collateral you thought you had in the guarantor's assets is now out of your reach. By planning ahead, you may be able to successfully defend against an attempt by a bankruptcy trustee or other creditor to void the guaranty as a fraudulent transfer. At a minimum you want to consider the risk of avoidance and loss of collateral before things go bad.

Under the Federal Bankruptcy Code and the Michigan Uniform Fraudulent Transfer Act, guaranties may be susceptible to attack as fraudulent transfers. The avoidance of transfers intended by a debtor to defraud his creditors goes back a long way. Current statutes have their roots in the Statute of 13 Elizabeth (1570). What is a fraudulent transfer? It is a transfer of property or the incurring of an obligation by a debtor to defraud its creditors. The fraud may be either actual or constructive.

Fraudulent Transfers under the Federal Bankruptcy Code

What constitutes fraud?

The Bankruptcy Code permits a bankruptcy trustee to avoid a guaranty given within one year of the bankruptcy filing if: (1) the guaranty obligation was incurred with an actual intent to hinder, delay or defraud creditors, (that is, actual fraud); or (2) the guarantor received less than reasonably equivalent value, and

(a) was or became insolvent due to the guaranty; (b) was engaged in business with unreasonably small capital; or (c) intended to incur debts beyond the guarantor's ability to pay its creditors. This constructive fraud is sometimes referred to as the "pure heart-empty head" type of fraud because the guarantor's intent is irrelevant.

If the guarantor is financially strong and will remain so, constructive fraud is not a concern, as a key element of constructive fraud is the guarantor's inability to pay its creditors. In other words, if the guarantor can afford to pay its creditors and the guaranteed debt, there is no problem under the statute. If this is not the case, you need to determine whether the guarantor received reasonably equivalent value.

Has the guarantor received reasonably equivalent value?

There is a presumption that transfers made or obligations incurred for the benefit of a third party (such as a guaranty) are not supported by reasonably equivalent value. Under this general rule, a guaranty is avoidable to the extent that an insolvent guarantor has not received benefits relatively equal to the guaranteed debt.

What constitutes reasonably equivalent value? There is no definition in the Bankruptcy Code, but there are numerous court decisions dealing with this question. This issue is most often litigated in situations where there is no perceptible direct benefit for the guarantor such as a subsidiary guarantying the loan of its parent and thereby being rendered insolvent. The subsidiary files for bankruptcy and the guaranty comes under attack.

There are steps you can take if fraudulent transfer issues are a concern.

Now what? First, there may be some direct benefit to the extent that the subsidiary actually received the proceeds of the loan. What if, however, the subsidiary only received a portion of the loan proceeds? Fortunately for financial institutions, the courts recognize that lenders do not operate in a vacuum, and they will take into consideration indirect benefits as well as direct benefits received by a guarantor.

These indirect benefits could include economic benefits received by the guarantor from an ongoing business relationship between the borrower and the guarantor. Assume for example that the parent of the guarantor borrowed the funds to purchase cable television companies so that the subsidiary would have an increased market for the sale of its programming. Under those circumstances, the indirect benefit was found to be reasonably equivalent. Also, in situations where the continued health and existence of the borrower is vitally important to the guarantor, such as a vital supplier or customer, a very good case could be made that the guarantor received reasonably equivalent value. Where a parent is guarantying a loan to its subsidiary (a so-called "downstream guaranty"), reasonably equivalent value will usually be found to exist.

An identity of interests between a borrower and a guarantor has also been recognized by the courts as providing benefit. In situations where the borrower and the guarantor are so related or situated that what benefits one, will benefit the other, they would share such an identity of interests.

Was the guarantor insolvent or rendered insolvent?

This is a very important question. Even if the guarantor has not received reasonably equivalent value, the guaranty will still be enforceable if the guarantor was solvent at the time of the guaranty. Under the Bankruptcy Code, a debtor is insolvent if the sum of its debts is greater than the value of its assets based on a fair valuation of both. In determining solvency under this formula, fair market value, not book value, of debts and assets

is used. A guaranty must be included as debt in making the calculation.

Fraudulent Transfers under Michigan Law

In 1998, Michigan adopted the Uniform Fraudulent Transfer Act ("MUFTA"), which provides an additional basis for creditors of a guarantor, including a bankruptcy trustee, to avoid a guaranty. MUFTA is a revised version of the Uniform Fraudulent Conveyance Act ("UFCA"), which had been in effect in Michigan until the enactment of MUFTA. Many of the changes made to the UFCA were modeled on revised provisions of the Bankruptcy Code, so MUFTA's provisions are very similar to those of the Bankruptcy Code. As under the Bankruptcy Code, guaranties under MUFTA are avoidable for actual or constructive fraud. Also, the concepts of reasonably equivalent value and insolvency contained in MUFTA are essentially the same as those concepts found in the Bankruptcy Code.

Under MUFTA, a guaranty will be avoidable where: (1) the guarantor incurred the obligation with an actual intent to hinder, delay or defraud a creditor; or (2) the guarantor did not receive reasonably equivalent value, and (a) the guarantor was engaged or was about to engage in a business or transaction for which the guarantor's remaining assets were unreasonably small, or (b) the guarantor intended to incur, or believed or reasonably should have believed that the guarantor would incur debts beyond the guarantor's ability to pay; or (c) the guarantor was insolvent at the time of the guaranty or became insolvent as a result of the guaranty. Under MUFTA only an existing creditor can avoid a constructively fraudulent guaranty where the guarantor is insolvent at the time of the guaranty, or is rendered insolvent by the guaranty. Either an existing or subsequent creditor may avoid a constructively fraudulent guaranty under (2) (a) or (2) (b) above.

The Bankruptcy Code has a one year statute of limitations for fraudulent transfer actions. Under MUFTA the statute of limitations varies from one to six years depending on the basis for

the action. Under a provision of the Bankruptcy Code, a bankruptcy trustee is given the rights of actual unsecured creditors under applicable law. In other words, the bankruptcy trustee can, under certain circumstances, rely on MUFIA and Michigan's more generous statute of limitations to avoid fraudulent transfers.

Steps You Can Take

There are steps you can take if fraudulent transfer issues are a concern. When dealing with start up companies, cross-stream guaranties or upstream guaranties, you should obtain evidence demonstrating the solvency of the guarantor. If the guarantor is not financially strong, you should document and make part of the file all direct benefits received by the guarantor. Review the anticipated flow of funds and determine the amount of loan proceeds the guarantor will re-

ceive. Also note in the file any indirect benefits the guarantor may receive. Is the financing for a group of related entities and part of a package with terms more favorable than the related companies could obtain independently?

When structuring the credit, you should consult with counsel and determine what the risks are in your particular set of circumstances. Also there are provisions which counsel can add to a guaranty, such as limiting the guaranty to the guarantor's net worth. Although not tested in the courts, these provisions may work to save the guaranty from avoidance.

By discussing these issues with counsel at the time of the loan origination, you could avoid some nasty surprises in the future. If the credit runs into trouble, you will be glad you did.



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