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If You Are Taking a Distressed Seller to “the Cleaners,” You May Be Setting Yourself Up for a So-Called “Fraudulent Conveyance” Claim

So you finally closed that big real estate acquisition, and what a great deal it was. The distressed seller was forced to unload the property at a heavily discounted price. A few months later you learn that the distressed seller files for bankruptcy. Too bad you say, but at least that is not your problem. You might be very wrong about that.

Under the U.S. Bankruptcy Code, the trustee of the bankrupt seller's estate may be able to unwind your transaction if the transaction meets the tests of a “fraudulent transfer.” However, the term “fraudulent transfer” is misleading. For bankruptcy purposes, “fraudulent transfers” are not limited to transactions that are propelled by an actual intent to defraud a creditor. The U.S. Bankruptcy Code also gives the bankruptcy court the right to set aside a previous transfer (going back as long as 6 years in some states) if the debtor received less than “reasonably equivalent value” and just one of several other triggers are met. Those other triggers include (a) the debtor was insolvent when the transfer was made, (b) the debtor became insolvent as a result of the transaction, or (c) the debtor was engaged in a business or transaction for which its remaining property constituted unreasonably small capital. What's more, the “set-aside” is not the only remedy available to the bankruptcy court. Instead of unwinding the transaction, the bankruptcy court can maintain the transaction in place, but force you to pay more - perhaps a lot more - for the property so that the total amount you paid reflects what the bankruptcy court determines is the “reasonably equivalent value” for the property. Think of what that repricing could do to the IRR on your recent investment!

The risks outlined above are quite real. Given the bankruptcy filing of the debtor and a little 20/20 hindsight, it is not much of a stretch for a bankruptcy court to conclude that your seller was sufficiently financially distressed so as to be considered insolvent. Also, the discounted purchase price you achieved through painstaking negotiations may be deemed too favorable to the buyer, such that it edges the bankruptcy court to conclude that the seller did not obtain “reasonably equivalent value” when it unloaded the property to you. Moreover, we have found that as the structure of a transaction becomes more complicated, there are more opportunities to find a lack of “reasonably equivalent value” for the seller.

What is a buyer to do? One traditional alternative is quickly becoming unavailable - title insurance. Depending on the state, title companies would frequently assume the risk of a fraudulent transfer claim and offer title insurance to protect against it. Indeed, this had become so common that title companies were charging only a nominal amount for the appropriate coverage. That has now changed. With increasing frequency, we are experiencing a reluctance, and in some cases outright refusals, on the part of title companies to issue coverage for this risk. Among several reasons for abandoning the coverage, title companies point to the extensive financial due diligence necessary to issue the coverage. Title companies want to focus on real estate matters, not balance sheet analysis. Undoubtedly, the recent financial upheaval

has had something to do with this change as well. We have even heard that title companies believe the industry as a whole will stop providing this coverage entirely by the end of 2010, even for straight-forward transactions that present minimal fraudulent transfer risk. Even if a title company would provide the coverage, that might provide a false sense of security, since the coverage is limited to the face value of the policy. That amount could be insufficient if a bankruptcy court imposes a new, higher price on the deal. What this all means is that buyers now need a new approach to address the increasing risks of fraudulent transfer claims.

Rather than look to title companies, you, as a buyer, now need to do your own diligence of both the seller and the seller's side of the transaction. If unacceptable risks are uncovered, you and your counsel can, with creative planning, structure the transaction to reduce that risk. In other circumstances, just by collecting important information when it is most readily available, you will be in a better position later to defend any subsequent claim. By focusing with your counsel on this growing area of concern before you close, you can better understand and manage the fraudulent transfer risks, and increase the odds that the great deal you closed, remains so.

If you have a need for legal advice on any of the above matters, please contact any of the following partners in our **Distressed Real Estate Practice Group**:

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