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From the Bankruptcy Courts

Benjamin Weintraub and Alan N. Resnick***

INDIRECT ECONOMIC BENEFIT AS FAIR CONSIDERATION IN FRAUDULENT CONVEYANCE CASES

The roots of the law of fraudulent conveyances can be traced back to the Statute of Elizabeth, an early English statute enacted in 1570 "[f]or the avoiding and abolishing of feigned, covinous and fraudulent . . . conveyances . . . [which] have been and are devised . . . to the end, purpose and intent, to delay, hinder or defraud creditors. . . ." [1]

The former Bankruptcy Act refined the concept of fraudulent conveyances by defining it to include constructive fraud. More particularly, Section 67(d) of the Act provided that "[e]very transfer made and every obligation incurred by a debtor within one year prior to the filing of a petition initiating a proceeding under this Act by or against him is fraudulent (a) as to creditors existing at the time of such transfer or obligation, if made or incurred *without fair consideration* by a debtor who is or will be thereby rendered *insolvent,* without regard to his actual intent. . . ." [2] The reason for defining a fraudulent conveyance in this manner is that Congress recognized that creditors' rights are unfairly jeopardized whenever a debtor whose assets are not sufficient to pay liabilities disposes of property for less than fair consideration, regardless of the debtor's motive. Consistent with this policy, "fair consideration" was defined in the former Act as something more than the consideration necessary to make a simple contract enforceable. Section 67(d)(1)(e) provided as follows:

> [C]onsideration given for the property or obligation of a debtor is "fair" (1) when, in good faith, in exchange and as a fair equivalent therefor, property is transferred or an antecedent debt is satisfied, or (2) when such property or obligation is received in good faith to secure a present advance or antecedent debt in an amount not disproportionately small as compared with the value of the property or obligation obtained.

The increase in corporate affiliations and multitiered corporations in modern commercial society has resulted in more three-sided credit transactions involving intercorporate guarantees. These situations present special difficulties in applying the "fair consideration" standard, especially when an insolvent entity guarantees and secures the debt of a separate but affiliated corporation. A recent case, *Rubin v. Manufacturers Hanover Trust Company,* [3] explores

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[1] Stat. 13 Eliz. c.5 (1570).

[2] Former Bankruptcy Act § 67(d)(2) (emphasis added).

[3] 661 F.2d 979 (2d Cir. 1981).

this problem. Although it was decided under the provisions of the former Act, *Rubin* should remain as persuasive authority under the fraudulent conveyance provisions of the Bankruptcy Code.

Rubin v. Manufacturers Hanover Trust Co.

The complex fact pattern in *Rubin* involved "a sort of private banking empire" [4] controlled by two individuals, John M. Trent and Eugene Skowron (Trent/Skowron). The companies controlled by Trent/Skowron provided banking-type services primarily to lower-income persons who did not maintain ordinary checking accounts. As part of the system, U.S.N. Co., Inc. (USN) and Universal Money Order Co., Inc. (UMO), two affiliated companies; were in the business of issuing money orders. Both USN and UMO were owned entirely by International Express Company (International), which was a holding company controlled by Trent/Skowron.

USN and UMO did not sell their money orders directly to the public. Although the money orders were sold through a variety of retail stores, the firms'principal sales agents were a number of check-cashing establishments located in large cities. These check-cashing services provided customers with the cash needed to buy the bankrupts' money orders. Similarly, the sale of money orders aided the check cashers in their principal business by reducing the cash outlays associated with it. "This symbiotic relationship with the check casher sales agents was vital to the money order issuers." [5]

As business developed, Trent/Skowron expanded into the check-cashing business by forming Empire Small Business Investment Corporation (Empire) which they used as a holding company to acquire a controlling interest in National Payroll Services Ltd. (National), itself a holding company that owned eleven check-cashing corporations, and to acquire a controlling interest in TWO Check Cashing Corp. (TWO), another holding company that owned four check-cashing firms.

The complexity of this system was illustrated by a chart with which the court summarized the relationships of the various affiliates[6]:

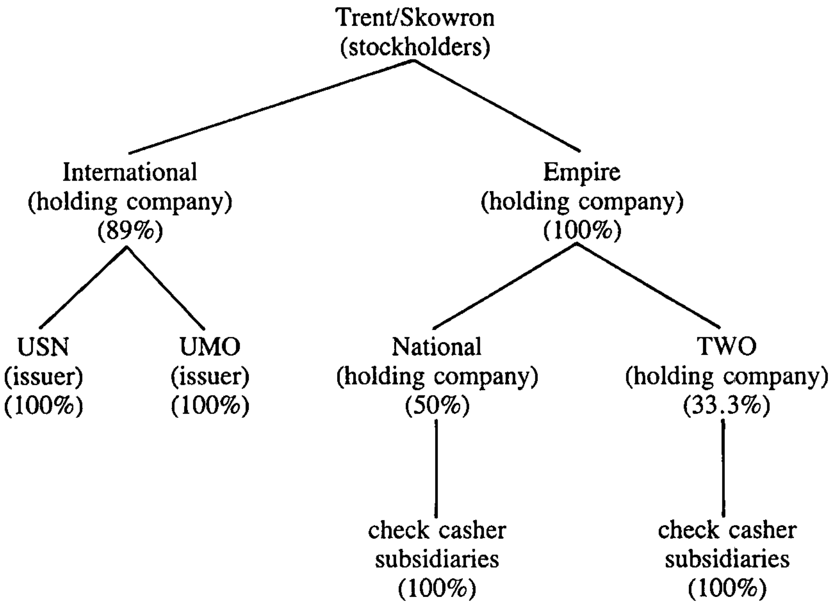
Manufacturers Hanover Trust Company (the Bank) was the principal banker for this network of affiliates and made various loans to several of the above entities as well as independent check-cashing establishments which issued UMO and USN money orders.

Financial problems existing in the check-cashing and money order businesses quickly resulted in the former as sales agents for USN and UMO experienced a constant need for cash, which could not be wholly satisfied from a sale of the money orders. There was a danger that the check

[4] *Id.* at 981.

[5] *Id.* at 982.

[6] *Id.*



[Numbers in parentheses indicate the percentage of the stock of the corporation owned by the entity immediately above it in the chain of ownership.]

cashers would run out of currency which would mean an inability to conduct the principal business. Moreover, if the cashers became unable to cash checks, then many prospective customers of UMO and USN would be unable to obtain the cash needed to purchase money orders. Additionally, other problems concerned the money issuers: the check casher's temptation "to retain the proceeds of his money order sales for use in his own business rather than remit them promptly to the issuer. Such foot-dragging could have disastrous consequences for the issuer, whose profit depends largely on his freedom to exploit the 'float' inherent in his business. . . . Any delay in the remittances of sales proceeds to the issuer necessarily diminishes the 'float', and therefore the profitability of the issuers' business." [7] Indeed, as the district court has found, "the importance of the float to USN and UMO can be seen in the precipitous collapse that followed the loss, in January 1977, of one day's float." [8]

In an effort to resolve these problems, Trent/Skowron arranged in 1964 for financing for the check-cashing firms with the Bank where

[7] *Id.* at 982-983. The "float" enabled the use and investment of proceeds of money orders sales between the time of purchase and the time when the money orders were presented for collection.

[8] *Id.* at 983 n. 7.

USN maintained an account. "This three-sided financing arrangement whereby MHT [the Bank] loaned money to the check cashers [about thirteen entities in the aggregate] according to the schedules submitted by Trent and Skowron, remained an essential operating procedure until the Trent/Skowron network collapsed in January 1977." [9]

Although the original loan line to the check cashers started out on the basis of the check cashers' own credit, a supplementary line of credit was arranged by Trent/Skowron in 1966 for the check cashers. Under the latter arrangement, Trent/Skowron pledged certain securities, owned by them, as collateral and the Bank extended credit to the cashers, in accordance with monthly schedules submitted by Trent/Skowron in a total amount that was fixed as a varying multiple of the value of the collateral. These schedules requested loans to each check casher for each day of the month, based on each cashers' estimated varying daily needs. The Bank would review the schedules and extend the specified credit. In sum, under the initial line of credit provided for the check cashers by the Bank, they were able to borrow on their own credit. On the supplementary line, the cashers were able to draw on the strength of the Trent/Skowron collateral as necessary to meet the peak demands of their business. In any case, the repayment of all of these loans was primarily the responsibility of the check cashers.

In 1970, Trent/Skowron executed a series of agreements with the Bank whereby they guaranteed the debts of the check cashers to the Bank, gave the Bank a lien on their accounts, and pledged other property to secure advances made to the check cashers. "Under the 1970 guarantee, the check cashers' loan lines were no longer tied to their own creditworthiness, but were predicated entirely on the financial strength of Trent and Skowron." [10]

Subsequently, the Bank obtained a series of guarantees and cross-guarantees "from various entities in the network in order to ensure that it would be able to look to the assets of any of the Trent/Skowron entities in the event of a default by the check cashers." [11] Under each guarantee agreement, the guarantor granted the Bank a security interest on certain of its assets. In 1972, USN granted the Bank a security interest in all its money, securities, and other property then or thereafter in the Bank's possession to secure USN's guarantee of the debts of Trent/Skowron and UMO. In addition, UMO executed a guarantee of Trent/Skowron's debts and granted the Bank a similar broad lien. In 1976, along with additional guarantees of the debts of Trent/Skowron, UMO pledged a $187,000 certificate of deposit as well as other collateral.

After the execution of these guarantees, the number of check cashers financed under the Trent/Skowron loan lines increased. At their peak, the check cashers' borrowings from the bank totaled approximately $12 million and were secured by $3 mil-

[9] *Id.* at 983.

[10] *Id.*

[11] *Id.*

lion worth of collateral under the guarantees.

In 1976, the Trent/Skowron enterprise experienced problems with remitting moneys for sales of food stamps and again the Bank came to the rescue by making an additional $500,000 in credit available to National and TWO, which used the funds to settle the food stamp accounts of their check casher subsidiaries. Under the cross-guarantees, the affiliated corporations, including USN and UMO, were liable for the increased loan line debts of National and TWO.

There followed an examination of the books of UMO by the California Banking Department which resulted in a finding that UMO had a negative net worth. The downhill trend continued with the New York State Banking Department ordering USN to discontinue the sale of money orders. UMO, unable to redeem $5.3 million worth of outstanding money orders, filed a Chapter XI petition on January 12, 1977, and was eventually adjudicated a bankrupt. On January 20, 1977, USN filed a petition in bankruptcy and announced that it could not redeem $5 million of outstanding money orders.

Prior to the filings and on January 11, 1977, the Bank set off the funds in checking accounts of USN and UMO in the sum of $295,000 and $80,000 respectively and applied them against loans aggregating $1.55 million. Subsequently, pursuant to a stipulation with the trustee, the Bank sold the various securities pledged by UMO for $1.387 million under the 1976 guarantee of the debts of Trent/Skowron. The moneys were applied to loans due from several of the Trent/Skowron check cashers and the excess balance of the sales proceeds were paid to UMO's trustee. In the aggregate, a total of $1.489 million worth of bank deposits and securities owned by UMO and USN and used as collateral was seized and retained by the Bank to repay loans advanced to check-cashing firms in the Trent/Skowron network.

The bankruptcy trustees of USN and UMO instituted actions against the Bank to recover the sum of $1.489 million for the benefit of the bankrupts' creditors, comprised principally of holders of unredeemed money orders. The theory of the actions was that the USN and UMO guarantees and grants of liens to secure debts of other entities in the Trent/Skowron network constituted fraudulent conveyances pursuant to Section 67(d) of the former Bankruptcy Act. In order to prevail, "the trustees were required to show: (1) that USN and UMO made transfers or incurred obligations to MHT within one year of the January 1977 filings of their bankruptcy petitions, (2) that these transactions were entered into without "fair" consideration to USN and UMO, and (3) that the bankrupts were, or were rendered, insolvent or insufficiently capitalized as a result.[12]

The Timing of the Transactions

Although the question of the timing of the transactions could have been avoided by applying the Uniform Fraudulent Conveyances Act, adopted in the Debtor and Creditor

[12] *Id.* at 989.

Law of New York,[13] which would have allowed the trustees to avoid fraudulent transfers occurring prior to the one-year period set forth in Section 67(d), the court of appeals held that the obligations incurred and transfers made by the bankrupts occurred when the check cashers drew on the loan credit lines, not when the guarantees and security agreements were first executed. "Until the loans were made, there existed only a framework through which USN and UMO might incur obligations, but they had not done so yet." [14] Because loans were made within the one-year prebankruptcy period, Section 67(d) did apply.

Was There "Fair" Consideration?

The trustee's position was that USN and UMO incurred obligations under their fair guarantees and granted security interests in their assets for advances made not to themselves, but to other and separate entities in the Trent/Skowron network. The trustees argued that no benefit was received by USN and UMO and, accordingly, they did not receive fair consideration. On the other hand, the Bank argued that the loans to the check-cashing firms did benefit USN and UMO *indirectly*. The loans enabled check cashers to settle their accounts with USN and UMO more quickly, thereby increasing both the pool of funds available to redeem money orders and the "float" from which profits were derived. Certainly, providing sufficient cash for the check cashers to stay in business maintained the stream of money order sales proceeds needed by USN and UMO. Such economic benefit, according to the Bank, constituted fair consideration. The district court agreed with the Bank's position. Basing its decision on a finding that there was an "identity of interest" [15] between USN, UMO, National, and TWO, the indirect economic benefit enjoyed by the bankrupts by reason of loans to the check cashers amounted to fair consideration. In analyzing this issue, the district court characterized the Trent/Skowron enterprises as "one ball of wax" [16] despite the barriers of corporate form.

In reversing the district court's holding on the fair consideration issue, the court of appeals rejected both the trustees' and the Bank's positions. The trustees' position, based on the proposition that the debtor receives no consideration when a loan is made to a third party, was too narrow for the court. After citing cases which held that the transfer of property for the benefit of a third party does not constitute fair consideration,[17] the court stated:

> The cases recognize, however, that a debtor may sometimes receive "fair" consideration even though the consideration given for his property or obli-

[13] N.Y. Debtor-Creditor Law Art. 10 (McKinney's).

[14] Rubin v. Manufacturers Hanover Trust Co., note 3 *supra*, at 990.

[15] *Id.* at 992.

[16] *Id.* at 988.

[17] The court cited *In re* Christian & Porter Aluminum Co., 584 F.2d 326, 337 (9th Cir. 1978); Bennett v. Rodman & English, Inc., 2 F. Supp. 355 (E.D.N.Y.), *aff'd per curiam* 62 F.2d 1064 (2d Cir. 1932). See Rubin v. Manufacturers Hanover Trust Co., note 3 *supra*, at 991.

> gation goes initially to a third person. . . . If the consideration given to the third person has ultimately landed in the debtor's hands, *or if the giving of the consideration to the third person otherwise confers an economic benefit upon the debtor,* then the debtor's net worth has been preserved and §67(d) has been satisfied—provided, of course, that the value of the benefit received by the debtor approximates the value of the property or obligation he has given up. For example . . . an individual debtor's repayment of loans made to a corporation, where the corporation has served merely as a conduit. . . . Similarly, fair consideration will often exist for a novation, where the debtor's discharge of a third person's debt also discharges his own debt to that third person . . . and it may sometimes be found in multi-party transactions of greater intricacy. . . .[18]

The court's rationale was as follows:

> In each of these situations, the net effect of the transaction on the debtor's estate is demonstrably insignificant, for he has received albeit indirectly, either an asset or a discharge of a debt worth approximately as much as the property he has given up or the obligation incurred. Thus, although these indirect benefit cases frequently speak as though an "identity of [economic] interest" between the debtor and the third person sufficed to establish fair consideration . . . the decisions in fact turn on the statutory purpose of conserving the debtor's estate for the benefit of creditors.[19]

Accordingly, the mere fact that the check cashers, rather than USN and UMO, received the loan advances did not compel a finding of no fair consideration for USN and UMO's guarantees and security agreements.

On the other hand, the Bank's position that "the existence of *any* indirect benefit *whatever* to USN and UMO from the advances . . . meant that the issuers' obligations as guarantors were necessarily supported by fair consideration," [20] was also too extreme. In a transfer for security, Section 67(d)(i)(e) requires that the advance be "not disproportionately small as compared with the value of the property or obligation" given by the bankrupt to secure it. However, in a three-sided transaction "it is not enough merely to compare the absolute amount of the third person's debt with the amount of security given by the bankrupt." [21] The trustees' burden of proving lack of fair consideration could be established "by proving that the value of what the bankrupt actually received was disproportionately small compared to the value of what it gave. Accordingly, the court must attempt to measure the economic benefit, if any, that accrued to each bankrupt as a result of the third person's indebtedness, and it must then determine whether that benefit was 'disproportionately small' when compared to the size of the security that that bankrupt gave and the obligations it incurred." [22]

The district court failed to make such an analysis. Although it held generally that USN and UMO had a vital interest in having the Bank make the loans, "it did not attempt to quantify the indirect benefits to either

[18] *Id.* at 991-992 (emphasis added and citations omitted).

[19] *Id.* at 992 (citations omitted).

[20] *Id.* at 993 (emphasis added).

[21] *Id.*

[22] *Id.*

issuer or to compare those benefits with the obligations assumed by the issuers under the guarantees." [23] The court then set forth a detailed inquiry to be followed by the trial court on remand. In essence, the district court must determine the extent to which the loans increased remittances from the check-cashing firms to USN and UMO.

> The court must then compare its estimate of the value thus received by each issuer with the magnitude of the obligation charged against that issuer under its guarantee. If the value received by either issuer is found to be disproportionately small as compared with its obligation, then, to that extent, the trustee for that issuer will have proved lack of fair consideration, and the court must proceed to consider the insolvency issue, discussed below. However, if either trustee fails to establish that the value is disproportionately small, the court must rule for [the Bank] against that trustee.[24]

The court of appeals was quick to add, however, that in making such determinations, the trial court "need not strive for mathematical precision. Section 67(d) requires only 'fair' consideration, not a penny-for-penny exchange." [25]

Insolvency of USN and UMO

The court of appeals also held that the district court erred in holding that the bankruptcy trustees failed to prove that USN and UMO were insolvent at the time of the obligations and transfers made without fair consideration. An entity is insolvent within the meaning of Section 67(d) "when the present fair salable value of his property is less than the amount required to pay his debts." [26]

First, the district court placed too much emphasis on the financial health of the Trent/Skowron network as a whole when it found that UMO was solvent. Corporate lines must be respected and, therefore, "the insolvency issue hinges on the financial position of the debtor, not on that of related entities." [27]

The second error made by the district court was in placing undue emphasis on book value of the debtors' assets. The proper approach is to determine market value of assets, which may differ significantly from its book value. Finally, the district court's focus on the time of the transactions as being the time when guarantees were executed, as opposed to when loans were advanced, tainted any finding with respect to the debtors' insolvency at the time of the alleged fraudulent obligation or transfer.

The Bankruptcy Code

The *Rubin* decision should remain as the persuasive authority in three-sided transactions involving guarantees of debts incurred by affiliated corporations when such transactions are challenged in cases governed by the Bankruptcy Code.[28] There are two reasons for such applicability.

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[23] *Id.*

[24] *Id.* at 994.

[25] *Id.*

[26] Former Bankruptcy Act § 67(d)(1)(d).

[27] Rubin v. Manufacturers Hanover Trust Co., note 3 *supra*, at 995.

[28] 11 U.S.C. § 101 et seq. The Bankruptcy Code governs all bankruptcy cases commenced on or after October 1, 1979.

First, challenges by trustees are often made under state fraudulent conveyance legislation. In many states, the Uniform Fraudulent Conveyance Act is controlling and is available to trustees by reason of Section 544(b) of the Bankruptcy Code.[29] It is that section which gives the trustee the power to avoid transfers and obligations that are voidable under state law by a creditor holding an unsecured claim. Moreover, the Uniform Fraudulent Conveyance Act is almost identical to Section 67(d) of the former Bankruptcy Act and uses the same concept and definition of "fair consideration."

Second, Section 548 of the Bankruptcy Code governing fraudulent transfers and obligations is similar to Section 67(d) of the former Act, although different terminology is used. Instead of using the term "fair consideration," the Code provides that a transfer or obligation is fraudulent if the debtor "received less than a *reasonably equivalent value* in exchange for such transfer of obligation." [30] Although it could be argued that the standard of "reasonably equivalent value"is stricter than the Act's standard of "an amount not disproportionately small as compared with the value of the property or obligation obtained," a quantitative analysis set forth in *Rubin* is still necessary to weigh the indirect economic benefit received by the debtor in bankruptcy when it guarantees or secures credit advances to a separate but affiliated entity.

[29] 11 U.S.C. § 544(b).

[30] 11 U.S.C. § 548(a)(2)(A) (emphasis added).