

The U.S. economy is still feeling the effects of a severe recession because of a global credit crunch. Almost all asset classes have substantially declined in value, and interest rates are near historical lows. As a result of these economic factors, estate planning lawyers see tremendous opportunities for individuals to transfer assets and establish long-term financing at low interest rates. In taking advantage of these opportunities, however, estate planning lawyers and their clients should be aware of and analyze the risk that a client's creditors may challenge an estate planning transaction as a fraudulent conveyance. Transfers of property pursuant to legitimate estate planning are typically not challenged as fraudulent conveyances during periods of regular economic growth. But, given that estate planning transfers typically reduce a client's assets and may have an incidental benefit of asset protection, such transfers that are made in times of economic volatility have an increased risk of being challenged as fraudulent by a transferor's creditors. This article explores the risks and potential consequences relating to fraudulent transfers that estate planning attorneys and their clients will face when undertaking customary estate planning techniques during an economic downturn.

In the current economic environment, a transfer of property by an individual that is part of customary and legitimate estate planning is nonetheless susceptible to being challenged as a fraudulent conveyance by the individual's creditors. Gifting property to relatives (or their trusts), selling ownership interests in a closely held business to relatives (or their trusts), re-titling property held by one or both spouses as entireties property, and purchasing life insurance are all customary and legitimate forms of estate planning that are designed to reduce estate taxes and ease the administration of an individual's estate. These transfers typically reduce the transferor's estate and can have the incidental benefit of asset protection, with the result that the

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# THE CASE FOR CAUTION

## Fraudulent Conveyance Risks in Estate Planning

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property transferred is placed out of the reach of the creditors of the transferor. Estate planning practitioners and their clients should therefore be aware of and take steps to mitigate the risk that such transfers may be challenged by the transferor's creditors under the laws that define and govern fraudulent transfers.

The central set of laws regarding fraudulent transfers are set forth in the Uniform Fraudulent Transfer Act (the "UFTA"). The UFTA was promulgated by the National Conference of Commissioners on Uniform State Laws in 1984 and has been adopted in all but a handful of states. The UFTA recognizes two types of fraudulent transfers—those involving constructive fraud and those involving actual fraud. Estate planning practitioners and their clients should be aware of the risks related to both of these types of fraudulent transfers.

### **Constructive Fraud Under the UFTA**

Section 5(a) of the UFTA defines a transfer as being constructively fraudulent if two conditions exist:

1. the transfer was made without the transferor receiving reasonably equivalent value in exchange for the transfer; and
2. the transferor was insolvent at the time of the transfer or is rendered insolvent as a result of the transfer.

In examining whether a potential transfer for estate planning purposes could be deemed constructively fraudulent, an estate planning attorney should examine both the nature and effects of the potential transfer.

### **Gifting**

By its very nature, gifting assets to a younger generation for estate planning purposes does not involve a transferor receiving a reasonably equivalent value in exchange for the transfer. An examination of whether a debtor is insolvent at the time of a gift, or will be rendered insolvent because of the gift, is therefore necessary to determine whether a gift made by a transferor could potentially be challenged as a constructively fraudulent transfer.

A debtor is considered insolvent under the UFTA if the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation. An estate planning practitioner who wishes to mitigate the risk that a client's gifting of property will be challenged as constructively fraudulent should therefore review and analyze a client's net worth before counseling the client to engage in gifting.

A thorny issue that typically arises when analyzing a client's net worth is the valuation of the client's liabilities. A client may be jointly liable on a loan or have a contingent liability relating to his or her personal guaranty of a debt. Analyzing the actual value of such joint and/or contingent liabilities is necessary in order to perform a thorough review of a client's net worth. The Official Comment to the UFTA states that the definition of "insolvent," as it appears in the UFTA, is derived from the definition of "insolvent" as that term appears in the U.S. Bankruptcy Code. In valuing a debtor's liabilities under the Bankruptcy Code, federal bankruptcy courts have held that contingent liabilities cannot be ignored but must be discounted based on the probability that the contingency will occur and that the liability will become real. See *In re Sierra Steel, Inc.*, 96 B.R. 275 (B.A.P. 9th Cir. 1989) (debtor who transferred funds to creditor within the 90-day period immediately before filing Chapter 11 petition brought suit against creditor to recover payment as preferential transfer; in determining whether debtor was insolvent at time of alleged preferential transfer, court valued contingent liability by discounting it by the probability that the contingency would occur and the liability would become real); *In re Wallace's Bookstores, Inc.*, 316 B.R. 254 (Bankr. E.D. Ky. 2004) (bankruptcy trustee for bookseller brought proceeding to set aside three allegedly preferential loan payments made to lender within the preference period; in determining value of liabilities for purposes of insolvency analysis, court held that value of contingent liability should be determined by multiplying the total debt guaranteed by the probability that the debtor will be required to fulfill the guaranty); *In*

*re Merry-Go-Round Enters., Inc.*, 229 B.R. 337 (Bankr. D. Md. 1999) (court denied defendant creditor's motion to dismiss Chapter 7 trustee's action to set aside preferential transfer; defendant argued that debtor was solvent at time of transfer and court, in analyzing solvency of debtor, held that the value of a contingent liability is determined in accordance with the probability that the contingency will not occur).

In addition, a bankruptcy trustee who is seeking to establish a debtor's insolvency under the Bankruptcy Code must generally produce expert testimony of an accountant or other financial expert who can testify as to the values of the items set forth on a debtor's balance sheet. See *In re Prime Realty, Inc.*, 380 B.R. 529 (B.A.P. 8th Cir. 2007) (appellate court affirmed bankruptcy court's determination that debtor was not insolvent at time of pre-bankruptcy transfers that were alleged by bankruptcy trustee to be preferential and constructively fraudulent; appellate court held that bankruptcy trustee failed to produce expert testimony of accountant or other financial expert supporting a finding that the debtor was insolvent at time of transfers); *In re Phongsittanak*, 353 B.R. 594 (B.A.P. 8th Cir. 2006) (appellate court affirmed bankruptcy court's holding that transferor was not insolvent at time of transfers of real estate alleged to be fraudulent, reasoning that expert testimony presented by transferee supported bankruptcy court's findings).

Although the Official Comment to the UFTA and federal bankruptcy case law provide insight into the definition of insolvency and the valuation of joint and contingent liabilities under the UFTA, these resources will not be controlling authority under a state law fraudulent transfer analysis. As such, in valuing a debtor's net worth, a practitioner also should examine the relevant state's adopted version of the UFTA and accompanying case law to determine whether the state has adopted a method of valuing a debtor's joint and contingent liabilities.

### **Other Estate Planning Techniques**

In addition to gifting, other estate planning transfers should also be analyzed to determine whether the transferor is insolvent or will be rendered insolvent by

the transfer. If a transferor's insolvency is determined to be an issue, an examination should be made into whether the transferor will receive "reasonably equivalent value" in exchange for the transfer. Although a lack of reasonably equivalent value will be most readily evidenced by a substantial difference between an asset's fair market value and the purchase price, a practitioner should examine state statutes and case law to determine whether the relevant jurisdiction has set forth particular standards under its version of the UFTA. At least one state's courts have held that the proper analysis of whether a transferor received "reasonably equivalent value" is to examine whether the consideration received by the transferor has utility from the creditor's perspective. See *SEC v. Resource Dev. Int'l, LLC*, 487 F.3d 295 (5th Cir. 2007) (receiver for corporation that operated as a Ponzi scheme brought suit under Texas's version of the UFTA to avoid corporation's prior payment of funds to third party; court held that the primary considerations in analyzing the value received in exchange for transfer alleged to be constructively fraudulent are the degree to which debtor's net worth was preserved and whether the consideration received had utility from a creditor's viewpoint).

An attorney who is assisting a client in estate planning transfers of property that do not involve gifting should therefore undertake a two-step process. The first step is to examine whether the client, under applicable state law, is insolvent at the time of the proposed transfer or will be rendered insolvent by such transfer. If this analysis indicates that the client is (or will be rendered) insolvent, the practitioner should then determine whether or not the client will receive "reasonably equivalent value," as that term is defined by relevant state statutes and case law, in exchange for the proposed transfer. If a transferor will not receive reasonably equivalent value in exchange for the proposed transfer and is insolvent (or will be rendered insolvent) at the time of transfer, the transferor will likely be participating in a constructively fraudulent transfer.

### **Actual Fraud Under the UFTA**

The UFTA states that a transfer may involve actual fraud when made with the actual intent to hinder, delay, or defraud any creditor of the transferor. A transferor's actual intent is a fact-intensive inquiry, and section 4(b) of the UFTA sets forth a non-exhaustive list of 11 factors to be considered when undertaking such an analysis. These factors include consideration of whether:

1. the transfer was to an insider (which includes certain relatives);
2. the debtor retained possession or control of the property transferred after the transfer;
3. the transfer or obligation was disclosed or concealed;
4. the debtor had been sued or threatened with suit before the transfer was made or obligation was incurred;
5. the transfer was of substantially all the debtor's assets;
6. the debtor absconded;
7. the debtor removed or concealed assets;
8. the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;
9. the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
10. the transfer occurred shortly before or shortly after a substantial debt was incurred; and
11. the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

The UFTA recognizes that this list of factors is non-exhaustive and therefore does not preclude a creditor from proving other facts and circumstances in support of an assertion that a transfer was actually fraudulent. At the same time, the non-exhaustive nature of the list does not preclude a transferor from asserting that the transfer was done pursuant to legitimate estate and tax planning or for other valid reasons. Although several states, in adopting the

UFTA, have made modifications and additions to this list, it is the authors' understanding that only North Carolina has specifically amended its version of the UFTA to expressly include legitimate estate or tax planning as a factor to be considered by courts in determining whether a transfer was made with fraudulent intent.

Given the fact-intensive inquiry whether a transfer will be deemed to have been made with the actual intent to defraud, hinder, or delay the transferor's creditors, an estate planning practitioner should carefully scrutinize and discuss with his or her clients the potential perception, surrounding circumstances, and effects of any transfers of property that are done for estate planning purposes.

### **Potential Consequences and Liability in the Event That a Transfer Is Deemed Fraudulent** **Client Consequences and Liability**

Section 7 of the UFTA sets forth a list of cumulative remedies available to a creditor of a transferor who has participated in a fraudulent transfer. These remedies include avoiding the transfer that is deemed fraudulent, obtaining an attachment (or other provisional remedy) against the property transferred or other property of the transferee, obtaining an injunction under which a transferor and/or transferee is prohibited from transferring the asset originally transferred or other property, and appointing a receiver to take charge of the asset transferred or other property of the transferee. If the creditor has a judgment against the transferor, the court also can allow the creditor to levy execution on the asset transferred or its proceeds. In addition, the UFTA grants a court the discretion to grant "any other relief the circumstances may require," subject to "applicable principles of equity and in accordance with the applicable rules of civil procedure." A practitioner concerned that an estate planning transfer could be alleged as fraudulent should therefore look beyond the UFTA and examine the relevant state's laws to determine whether additional remedies (other than those expressly set forth in the UFTA) may be available to a creditor; such remedies may include

the imposition of a constructive trust or an equitable lien (whereby property purchased with fraudulently transferred funds is subject to a lien in favor of the defrauded party).

Such remedies are not without limitations. For example, only the portion of a fraudulent transfer that is necessary to satisfy a creditor's claims is avoidable under the UFTA. At least two states have held that the transfer of the remaining property is valid and remains the property of the transferee. See *In re Sbriglio*, 306 B.R. 445 (Bankr. D. Conn. 2004) (debtors who had judgment lien placed on residential real property that was fraudulently transferred to daughter attempted to avoid creditor's judgment lien by including property in bankruptcy estate; court held that transfer was voidable as fraudulent conveyance to the extent necessary to project a judgment creditor's rights, but did not result in re-vesting of property in debtors); *In re Estate Partners, Ltd.*, 320 B.R. 295 (Bankr. W.D. Pa. 2005) (court imposed constructive trust, of which transferee was trustee, on fraudulently transferred assets to the extent necessary to satisfy creditors' claims). In addition, a practitioner should examine section 8 of the state's adopted version of the UFTA for additional defenses and protections that may be available to transferees of fraudulently transferred property.

In addition to the potential consequences of a fraudulent transfer under the UFTA, estate planning practitioners also should discuss with their clients the potential consequences under the Bankruptcy Code. A debtor who transfers property with the intent to hinder, delay, or defraud a creditor within the one-year period immediately before filing for bankruptcy will lose its discharge under Bankruptcy Code § 727. In addition, a trustee's avoidance powers under Bankruptcy Code § 548 extend to fraudulent transfers (actual and constructive) made within the two-year period immediately preceding a debtor's filing for bankruptcy. Importantly, the transfers that are deemed to be constructively fraudulent under the Bankruptcy Code are not limited to those made for less than reasonably equivalent value at the time the trans-

feror is insolvent (or the transfer renders the transferor insolvent). Rather, the Bankruptcy Code sets forth additional types of transfers for less than reasonably equivalent value that are deemed constructively fraudulent regardless of the solvency of the transferor. Although the focus of this article is on the UFTA, an estate planning practitioner should examine the Bankruptcy Code and determine whether any proposed estate planning transfer could be deemed fraudulent under the Bankruptcy Code, particularly given the expansive definition of constructively fraudulent transfers in the Bankruptcy Code.

Finally, if an estate planning practitioner assists a client in undertaking a transfer that is ultimately deemed fraudulent, it is possible that the transfer (that was originally performed for estate planning purposes) will be rendered ineffective. In such an instance, it is possible that a client will have an incomplete and/or inadequate estate plan, and a practitioner should re-evaluate the client's needs, objectives, and options in light of the finding that a previous transfer was deemed fraudulent.

#### Attorney Liability

As a general proposition, attorneys who assist clients with transfers of property in good faith and without actual or deemed knowledge that the transfers are fraudulent conveyances should not be liable to the clients' creditors or in violation of any ethical obligations that the attorneys may have under state law. In addition, attorneys who advise clients of the risks that a potential transfer could be deemed a fraudulent conveyance and undertake a customary degree of due diligence should not be liable to the clients for malpractice. Nevertheless, this is an area fraught with risks and expanded theories of liability. An attorney should be aware of three categories of consequences that can arise from assisting a client with a transfer that is ultimately deemed fraudulent. These three categories are liability to a client's creditors, liability to clients, and violation(s) of the relevant rules of professional conduct.

**Potential Liability to a Client's Creditors.** Generally speaking, attorneys do not have an affirmative duty to third parties, including a client's creditors. At least one state (Delaware) has modified its adopted version of the UFTA to provide immunity to attorneys or other advisors of a transferor who did not act in bad faith for the transfer that is deemed fraudulent. The section of Delaware's adopted version of the UFTA that addresses creditor remedies states that

[n]otwithstanding any other provision of law or equity, a creditor shall have no right to relief against any trustee, attorney, or other advisor who has not acted in bad faith on account of any transfer. For the purposes of this subsection, it shall be presumed that the trustee, attorney or other advisor did not act in bad faith merely by counseling or effecting a transfer.

6 Del. Code Ann. § 1307(c).

In addition, the courts of at least one state (Connecticut) have held that a creditor of a debtor has no valid cause of action against the debtor's attorney for aiding a fraudulent transfer, reasoning that the imposition of such liability has the potential of interfering with the ethical obligations owed by an attorney to the client. See *Nastro v. D'Onofrio*, 263 F. Supp. 2d 446 (D. Conn. 2003) (court dismissed judgment creditor's claims brought against debtor's attorneys under Connecticut's version of the UFTA; debtor's attorneys had prepared legal documentation creating offshore spendthrift trust to which closely held stock was transferred).

An attorney can become liable to a client's creditors in egregious circumstances, such as when the attorney is acting in bad faith and assists a client in making a transfer that the attorney knows is fraudulent. At least one state (New Jersey) has recognized a creditor's claims against a debtor's attorney for civil conspiracy to violate the UFTA and providing the creditor negligent misrepresentations about the debtor's net worth. See *Banco Popular N. Am. v. Gandi*, 876 A.2d 253 (N.J. 2005) (court recognized lender creditor's claims against debtor's attorney for civil conspiracy to violate the UFTA and negligent misrepresentations to lender creditor when attorney had counseled debtor to transfer assets outside of reach of specific judgment creditor, prepared documents necessary for transfer, and provided lender creditor an

opinion letter that debtor had not disposed of substantially all of debtor's assets).

In addition, one commentator has indicated that an attorney who knowingly assists a client with a fraudulent transfer may potentially be liable to the client's creditors under a theory of conspiracy or aiding and abetting, particularly if the attorney receives an interest in the property that has been fraudulently transferred. See Peter Spero, *Fraudulent Transfers: Applications and Implications* § 6.2 (2008). An estate planning attorney who serves as a trustee of a trust to which a client is transferring property for estate planning purposes should therefore examine the laws of the relevant jurisdiction to determine whether the status as trustee can potentially give rise to liability. An attorney also should avoid undertaking actions that can give rise to an affirmative duty to a client's creditors, such as giving the client's creditors representations regarding the client's net worth if the attorney knows that the representations are not correct. Understanding the laws of each jurisdiction and avoiding actions that give rise to a duty to a client's creditors should mitigate the risk that an attorney will be held liable by a creditor of a client who has participated in a fraudulent transfer.

**Potential Liability to Client.** If an attorney assists a client with an estate planning transfer that is ultimately deemed fraudulent, the client may be inclined to sue the practitioner for malpractice. These claims are rarely successful, but a lawyer that assists a client with customary estate planning should nonetheless mitigate the potential malpractice liability by (1) advising the client of the risks that a potential transfer could be deemed a fraudulent conveyance and (2) performing due diligence into the client's financial background. Such due diligence can include obtaining a financial statement from the client stating the nature and value of the client's assets and liabilities, obtaining a formal valuation of the client's assets and liabilities, and obtaining a representation from the client that the transfer is solely for purposes of estate planning, will not render the client insolvent, and is not being done with the intent to hinder, delay, or defraud a creditor.

In the event that an attorney counsels a client to engage in a transfer that is ultimately deemed fraudulent and the client brings a malpractice action against the attorney, the

attorney may raise the equitable defenses of *in pari delicto* and unclean hands. See *Dow v. Hyatt Legal Services*, 132 B.R. 853 (Bankr. S.D. Ohio 1991) (defendant attorney advised and assisted debtor-client with certain fraudulent real estate conveyances raised in motion to dismiss equitable defenses of *in pari delicto* and unclean hands against plaintiff-trustee's malpractice action; court recognized availability of defenses in context of claims involving fraudulent transfers but refused to dismiss plaintiff-trustee's actions based on lack of information in complaint and also recognized various exceptions to these equitable defenses). The availability of these equitable defenses is based on state law, and a practitioner should examine the relevant jurisdiction's law to determine whether the defenses can be raised against a malpractice claim.

Attorneys also should be aware of the potential risk that malpractice actions may be brought in the event that the client files for bankruptcy. Under Bankruptcy Code § 541, all of a debtor's legal and equitable claims become the property of the bankruptcy estate on filing for bankruptcy, and, as such, a bankruptcy trustee can bring a malpractice action against an estate planning attorney who assisted a client with a fraudulent transfer. See *Dow*, 132 B.R. 853 (court allowed claim brought by Chapter 7 trustee against debtor's attorneys alleging that attorneys were negligent in advising and representing debtor in transactions that were alleged by the trustee to be fraudulent). Note, however, that a trustee's malpractice claim against the debtor's attorney for assisting with a fraudulent transfer will be conditioned on findings that the transfer was fraudulent and the injury was actually inflicted on the transferor's estate. See *In re Environmental Res. & Dev., Inc. v. Resource Dynamics, Inc.*, 46 B.R. 774 (S.D.N.Y. 1974) (Chapter 11 trustee brought malpractice lawsuit against attorneys allegedly involved in fraudulent transfer of assets that debtor transferred to spin-off corporation; court held that malpractice claim was premature and placed the trustee's claims on the suspended docket of the court pending a ruling on whether the transfers were fraudulent and determination as

to whether trustee was able to avoid the transfer and recover the fraudulently transferred assets from the transferees).

**Professional Discipline.** The rules of ethics governing the conduct of attorneys varies on a state-by-state basis. Still, an attorney who acts in bad faith by assisting a client in making a transfer that the attorney knows will defraud a client's creditors will likely be in violation of the relevant jurisdiction's rules of professional conduct. The rules of conduct typically provide that an attorney shall not knowingly counsel a client to engage in fraudulent conduct. These rules, however, ordinarily do not preclude an attorney from discussing a potential course of conduct with a client, and an attorney may be permitted to discuss with a client the risk that a proposed transfer could be deemed fraudulent under the laws of the relevant jurisdiction.

The ethical rules that govern the conduct of attorneys are established on a state-by-state basis and vary among jurisdictions. A practitioner should therefore carefully examine the relevant jurisdiction's rules of professional conduct to ensure that he or she does not run afoul of ethical rules when assisting clients with estate planning transfers that could potentially be deemed fraudulent.

## Conclusion

Given the heightened likelihood that an individual's creditors will closely scrutinize customary estate planning transfers, practitioners should take precautions that mitigate the risk that the transfers will ultimately be deemed fraudulent. A practitioner should perform due diligence regarding a client's financial background, research and analyze relevant state and federal bankruptcy law, and discuss with the client the risks, potential perception, surrounding circumstances, and effects of any transfers of property that are done for estate planning purposes. Taking these steps and making well-informed decisions regarding a client's estate planning will decrease the likelihood that the transfers are in violation of the UFTA. ■