MAXIMUM ASSET PROTECTION
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FRAUDULENT TRANSFERS

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I. Fraudulent Transfers

A. Introduction

The modern American law governing fraudulent conveyances has its origins in the Statute of Elizabeth originally codified in the 16th century England. 13 Eliz. Ch. 5 (1571). The original penalty under the Statute of Elizabeth was the forfeiture of the property's value, half to the royal treasury and half to the creditor. Most English common law jurisdictions have adopted the Statute of Elizabeth in some form.

The Uniform Fraudulent Conveyance Act of 1918 was the first codification of the Statute of Elizabeth in the United States and was adopted by 26 jurisdictions. A more modern adaptation of that act is the Uniform Fraudulent Transfer Act (the "UFTA") adopted by California as of January 1, 1987.

The fraudulent transfer laws may apply and must be considered in connection with any transfer that diminishes the value of property owned by the debtor: transfers to family members, partnerships, trusts, corporations and other.

If the transfer is fraudulent, the creditors remedy, generally, is to set aside the transfer and proceed after the transferee. In certain cases, the court may even grant to the creditor injunctive relief (including pre-judgment) to prevent any further transfers. In the context of bankruptcy, a fraudulent transfer allows the creditor to avoid such transfer and can result in denial of relief to the debtor.

It is important to note that the fraudulent transfer laws will apply only to transfers of property in which the debtor holds a beneficial interest. This means that if the debtor simply holds legal title in the property (such as when property is retitled to facilitate a loan), the transfer of such property can not be set aside by a creditor.

Despite a common misconception, it is important to remember that a fraudulent transfer is not fraud. Fraud usually involves lying – "a knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment."[1] Thus, a used car dealer rolling back the odometer is committing an act of fraud. A plaintiff who proves fraud by the defendant is entitled to damages, including, possibly, punitive damages.

Unlike fraud, fraudulent transfers do not require a finding of fraud. As discussed below, a transfer maybe fraudulent without a finding of any ill intent on behalf of the debtor. Fraudulent

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[1] Black's Law Dictionary, 670-671 (7th ed. 1999).

transfers are valid transfers, but, as discussed below, may be voided by a creditor. This means that a fraudulent transfer of property is good for all legal purposes, except as to a creditor.

B. Current Law in California

1. UFTA

The UFTA is contained in the California Civil Code ("CCC") Sections 3439-3439.12. There are two types of fraudulent transfers. Those made with actual intent to defraud a creditor – here we are looking at the debtor's motivation for engaging in the transfer. CCC Section 3439.04 defines this type of fraudulent transfer as:

> **A transfer made** or obligation incurred by a debtor is **fraudulent** as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, **if the debtor made the transfer** or incurred the obligation as follows:
>
> (a) With **actual intent to hinder, delay, or defraud** any creditor of the debtor.
>
> (b) Without receiving a reasonably **equivalent value in exchange** for the transfer or obligation, and the debtor:
>
>> (1) Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
>>
>> (2) Intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due.
>
> (Emphasis added.)

The other type of a fraudulent transfer is one where the transfer is in essence a gift, and the debtor is insolvent. Here, the debtor's intent is irrelevant and the transfer is called constructively fraudulent. CCC Section 3439.05 provides:

> A **transfer made** or obligation incurred by a debtor is fraudulent as to a creditor whose **claim arose before the transfer** was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a **reasonably equivalent value in exchange** for the transfer or obligation and the **debtor was insolvent** at that time or the **debtor became insolvent** as a result of the transfer or obligation. (Emphasis added.)

The creditor has a limited amount of time to bring a fraudulent transfer action. CCC Section 3439.09 provides in part:

> A cause of action with respect to a fraudulent transfer…is extinguished unless action is brought…
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>> (a) Under subdivision (a) of Section 3439.04 [intent to hinder, delay, defraud], within **four years after the transfer was made**... or, if later, within **one year** after the transfer…could reasonably have been **discovered by the claimant**.

> (b) Under subdivision (b) of Section 3439.04 or Section 3439.05 [equivalent value not received in return for transfer], within **four years** after the transfer was made…
>
> (c) Notwithstanding any other provision of law, a cause of action with respect to a fraudulent transfer or obligation is **extinguished** if no action is brought or levy made within **seven years** after the transfer was made or the obligation was incurred.

2. Transfers

A conveyance of property by a debtor will be treated as a "transfer" for fraudulent transfer purposes if such conveyance diminishes the value of debtor's property.[2] This means that if the debtor conveys fully encumbered property (*i.e.*, property with no equity), that will not be treated as a transfer.[3] Similarly, if the transferred property is covered by an available exemption, that cannot be a fraudulent transfer because it does not diminish what the creditor may receive.[4]

The California Civil Code defines the term "transfer" as every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with an asset or an interest in an asset, and includes payment of money, release, lease, and creation of a lien or other encumbrance.[5]

In addition to transactions that are transfers on their face, certain other events may be treated as transfers: inaction, a waiver of defenses, the termination of a lease, an extension of a loan, a disclaimer, making a tax election, withdrawing cash from a deposit account, granting a security interest in property, conversion of nonexempt assets into exempt assets (even though the transaction can be characterized as a debtor transferring assets to herself), perfecting a security interest or obtaining a lien, and rental of property for less than fair market value.

Just as it is important to know what would constitute a transfer, it is equally important to know what would not be a transfer: a clerical action (like retitling property to correct title), a transfer (by operation of law) by someone other than the debtor, or a mandatory (by operation of law) transfer by the debtor. For example, a transfer of assets to an ex-spouse pursuant to a divorce decree does not constitute an avoidable transfer.

Additionally, indirect transfers are not treated as transfers. For example, a transfer by a corporation controlled by a debtor is not treated as a transfer being made by the debtor.

In a transaction where the debtor acquires an asset or sells an asset, the transfer takes place when the obligation to pay consideration arises. Thus, on a transfer of land for a promissory note, the

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[2] Collier on Bankruptcy (15th ed. 1993).

[3] CCC Section 3439.01(a)(1). Mehrtash v. ATA Mehrtash, 93 Cal. App. 4th 75 (2001) (the transfer of real property subject to encumbrances, including judgment liens, could not be set aside as a fraudulent transfer, as the creditor could not show how she was injured).

[4] CCC Section 3439.01(a)(2). Reddy v. Gonzalez, 8 Cal. App. 4th 118, 122 (1992) (homestead property not subject to fraudulent transfer laws).

[5] CCC Section 3439.01(i).

transfer for UFTA purposes takes place when the first installment is due on the note.[6] The timing of the transfer may be of crucial importance, as it determines the value of the transferred property and must also coincide with intent to defraud.

3. Types of Fraud

As CCC Sections 3439.04(a) and (b) demonstrate, there are two types of fraudulent transfers: those done with an actual intent to defraud, delay or hinder a creditor, and those done for less than full consideration while the debtor was insolvent (constructive fraud).

a. Actual Intent

i. Looking for Intent

A transfer will be fraudulent if made with **actual intent** to hinder, delay or defraud any creditor.[7] Thus, if a transfer is made with the specific intent to avoid satisfying a specific liability, then actual intent is present. However, when a debtor prefers to pay one creditor instead of another that is not a fraudulent transfer.[8] For these types of fraudulent transfers, the transferor's intent is the primary factor.

Actual intent focuses on the mindset of the debtor at the time of the transfer. Regardless of the financial situation of the debtor, or the amount of the consideration received by the creditor, a showing of actual intent to defraud can be used to set aside any transfer.

One of the most important principles of asset protection planning is acting while the seas are calm. The importance of that principle is clearly evident in light of the actual intent test. The actual intent test requires the existence of a connection between the debtor and the creditor at the time of the transfer. If a debtor transfers assets when he or she has no creditors, then the debtor will obviously lack the requisite actual intent to defraud some specific person.

ii. Badges of Fraud

Evidence of actual intent is rarely available to a creditor for it would require proof of someone's inner thoughts. Because of that, creditors often have to rely on circumstantial evidence of fraud. To prove actual intent, the courts have developed "*badges of fraud*," which, while not conclusive, are considered by the courts as circumstantial evidence of fraud. The ten badges of fraud are:

1. Becoming insolvent because of the transfer;
2. Lack or inadequacy of consideration;
3. Family, or insider relationship among parties;
4. The retention of possession, benefits or use of property in question;

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[6] For bankruptcy law purposes, a transfer (for fraudulent transfer purposes only) will take place when the title in the transferred property is perfected in such a way that no one would be able to acquire title in the property superior to that of the transferee.

[7] CCC Section 3439.04(a). One should remember, that while the intent to defraud is usually the issue, a transaction can also be set aside for intent to delay or hinder, such as a contribution of assets to a partnership or a corporation.

[8] CCC Section 3432.

5. The existence of the threat of litigation;
6. The financial situation of the debtor at the time of transfer or after transfer;
7. The existence or a cumulative effect of a series of transactions after the onset of debtor's financial difficulties;
8. The general chronology of events;
9. The secrecy of the transaction in question; and
10. Deviation from the usual method or course of business.

The presence of one or more badges of fraud will serve to shift the burden of proof from the creditor to the debtor. Thus, at the outset the creditor is settled with the responsibility of establishing existence of this circumstantial evidence. When that is successfully accomplished, the debtor must then prove that despite this circumstantial evidence, the transfer was made with no fraudulent intent.

Badges of fraud were originally developed by the common law English courts. The same principles continue to apply today and there is a mounting body of case law on the subject. Based on these cases, the asset protection adviser should keep in mind the following pointers:

- Asset protection planning should not be secretive, or concealed. It should be open and recorded if involving real property.
- Transfers of assets should be accomplished at arm's length, following customary business practices, and should be papered like any other business transaction.
- Transfers to related parties, whether family members or controlled entities are always suspect and scrutinized more closely by the courts.
- Transfers should be made for adequate consideration, and, if possible, the sufficiency of such consideration should be supported by an appraisal.
- If there are currently outstanding claims against the debtor, any transfer of asset will be suspect. However, if the claims are frivolous or have no substance, they can probably be ignored.
- The debtor transferring the assets should avoid retaining any strings (control) over the assets, and should not retain any benefits from such assets.
- Finally, debtors who have a criminal past will be scrutinized more closely.

The most important badge of fraud is the debtor's financial condition at the time of the transfer, more specifically, if the debtor was insolvent at the time or as a result of the transfer, that is an important indication of actual intent. The insolvency situation is discussed in more detail below.

iii. Overcoming the Badges

Once the creditor produces enough badges to establish actual intent, the debtor will need to make a showing that while the badges of fraud were present, for some reason the transfer was not fraudulent.

Reliance on the advice of counsel is a common way to mitigate the badges. If the debtor seeks the advice or opinion of an attorney prior to the transfer, and is advised that the proposed transfer will not constitute a fraudulent conveyance, that strongly supports the debtor's position.

Remember, the debtor is trying to establish lack of intent to defraud, and seeking legal advice is a good way of accomplishing that.

However, reliance on advice of counsel is not an absolute shield. The debtor will have to establish that his or her reliance was reasonable, that all of the relevant facts were disclosed to the attorney and that the counsel's interpretation of the law was also reasonable.[9] Even if reliance is established, it is not a *per se* absolute defense, but only one of the factors that the court may consider.

The more frequent method of overcoming the badges of fraud is by establishing an independent business purpose for the transfer. For example, a transfer of life insurance into an irrevocable trust for the benefit of one's children certainly triggers some badges of fraud. But keeping in mind that the badges are used solely to infer intent, they can be overcome by establishing that the trust was set up as an estate planning tool, to minimize the debtor's estate on death. A transfer of assets to an entity controlled by the debtor may also trigger certain badges, but the debtor may attempt to establish that he was planning on engaging in a joint venture with other investors by utilizing the entity.

In asset protection planning, as in tax planning, establishing a viable independent business purpose is crucial. To be more effective, the business purpose should be established (*i.e.*, papered and documented) prior to the transfer.

b. Any Creditor

The actual intent test looks to the debtor's intent to defraud "any" creditor. The modifier "any" is very important. A creditor seeking to set aside a conveyance as a fraudulent transfer need not show that the debtor intended to defraud this specific creditor. The creditor need only show that at the time of the transfer the debtor sought to defraud some specific creditor.

However, while the debtor need only to have intent to defraud "any" creditor, that statement is somewhat misleading. For fraudulent transfer purposes, the world of creditors is divided into three classes: present creditors, future creditors, and future potential creditors.

CCC Section 3439.04 provides that the transfer may be deemed fraudulent "whether the creditor's claim arises before or after the transfer was made." This would seem to imply that any creditor, present or future, would be protected by the UFTA; which conflicts with the common law concept of the free alienability of property by its owner.

While the UFTA clearly applies to present creditors,[10] the distinction between a future creditor and a future potential creditor is not as clear. A future creditor is defined as a creditor whose claim arises after the transfer in question, but there was a foreseeable connection between the

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[9] See, e.g., In re Bateman, 646 F. 2d 1220 (8th Cir. 1981).
[10] A present creditor is a creditor holding a matured claim. Thus, creditors who filed a lawsuit, received a judgment or were just run over by the debtor (and thus accrued a claim against the debtor) are present creditors.

creditor and the debtor at the time of the transfer.[11] A future potential or contingent creditor is one whose claim arises after the transfer, but there was no foreseeable connection between the creditor and the debtor at the time of the transfer.[12]

Generally, a future creditor is one who holds a contingent, unliquidated or unmatured claim against the debtor. A transfer is fraudulent as to a future creditor if there is fraudulent intent directed at the creditor at the time of the transfer. For example, if a debtor is about to default on a personal guarantee, and transfers her assets in anticipation of such default, the holder of the guarantee is a future creditor and the transfer is made with intent to defraud the creditor.

A future creditor must not only be foreseeable at the time of the transfer of assets, the timing of such creditor's claim must be proximate to the time of the transfer. In one case, the court defined the term "future creditor" as on whose claim is "reasonably foreseen as arising in the immediate future."[13]

Future potential creditors are distinguished from future creditors by the fact that there is no intent to defraud a particular future potential creditor. For example, a debtor is worried that he has insufficient automobile insurance coverage and transfers his assets. Those who may in the future be run over by the debtor are future potential creditors, as there is no intent to run over a specific person.

Because the UFTA is commonly held to apply only to future creditors, but not to future potential creditors, asset protection planning focuses on future potential creditors.

To summarize, only a present or future creditor may bring a fraudulent transfer action under the actual intent test. Future potential creditors do not have standing to bring a fraudulent transfer action. It is also impossible for the debtor to have actual intent to defraud a person of whose existence the debtor is not aware.

Thus, the word "any" is somewhat misleading, because it does not really mean "any." The debtor must have a specific creditor in mind to form actual intent.

This distinction between what types of creditors are protected under the UFTA is easier to grasp by trying to visualize the faces of one's creditors. As a rule of thumb, if the debtor knows what the creditor looks like at the time of the transfer, that creditor is protected.

For example, if the lawsuit has been filed prior to the transfer of assets, the debtor knows what that creditor/plaintiff looks like. Thus, present creditors can be visualized with great specificity. If at the time of the transfer of assets the debtor has a good idea of what the creditor looks like (an accountant's pool of clients, a doctor's pool of patients, the business owner's creditor) these

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[11] For example, a doctor's pool of patients are future creditors of the doctor, as there is a foreseeable connection. (However, what is a foreseeable connection for an ob-gyn may not be a foreseeable connection for a oncologist.) The homeowner is the future creditor of the building contractor, because there is a foreseeable connection.
[12] For example, someone the debtor may run over tomorrow, is a future potential creditor today.
[13] Leopold v. Tuttle, 549 A. 2d 151, 154 (Penn. 1988).

are future creditors. If the debtor cannot picture what the creditor looks like because the debtor is not even aware of the existence of this creditor, this is a future potential creditor.

Of course, this is only a rule of thumb, but it does make these concepts easier to understand. The focus is on the relationship between the debtor and the creditor at the time of the transfer, as demonstrated in these examples:

Example 1: Dr. Brown runs over an old lady and her poodle. Fearing an imminent lawsuit, Dr. Brown transfers $20 to his brother. At the moment the old lady was run over, she became a present creditor.[14] Dr. Brown had specific intent to defraud her, and the old lady can seek to set aside the transfer of $20.

Example 2: Dr. Brown transfers $20 to his brother. Three days later he runs over the old lady and the unfortunate poodle. In this case, there is no foreseeable connection between Dr. Brown and the old lady at the time of the transfer of money. The old lady has no standing to attempt to set aside the transfer of money.

Example 3: Dr. Brown signed a contract to purchase a stethoscope. The other party to the contract became a "present creditor" as soon as Dr. Brown signed the contract.

Example 4: Dr. Brown is experiencing early stages of epilepsy. Afraid of mucking up a surgery, he transfers $20 to his brother. Two months later, Dr. Brown has an epilepsy attack during a surgery, and mayhem ensues. Can the mutilated patient attempt to set aside the transfer of $20? Because there is a foreseeable connection between the good doctor and the patient at the time of the transfer, and there is some proximity as to the timing of the claim and the transfer, the patient is a future creditor and has standing to challenge the transfer. Of course, an argument can be made in Dr. Brown's favor if the doctor-patient relationship did not exist at the time of the transfer. There is no clear guidance on this point.

c. Constructive Intent

CCC Sections 3439.04(b)(1), 3439.04(b)(2) and 3439.05 also provide that a transfer may be fraudulent without any actual intent to defraud a creditor if a transfer was made without receiving an equivalent value in return,[15] in one of three situations:

1. When a debtor was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction;
2. The debtor intended to incur, or believed or reasonably should have believed that he or she would incur debts beyond his or her ability to pay as they became due; and

[14] The old lady is a present creditor because she has a claim against Dr. Brown. A claim is a "right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured." UFTA Section 1(3).

[15] The law generally does not require the debtor to receive an exact same fair market value in return, but the values must be reasonably proximate. Practitioners generally use 70% as a guideline amount.

3. The debtor was insolvent at the time of the transfer, or the debtor became insolvent as a result of the transfer.

The fair market value of the property received in return is an important element of the fraudulent transfer laws. As a matter of fact, a creditor would have a most difficult time proving a fraudulent transfer where the debtor received full fair market value in return.

Fair market value is established through appraisals and valuations. It is very important to document the sufficiency of the value at the time of the transfer. Likewise, it is important to document that both the valuation and the transfer were achieved at arm's length. When a debtor transfers assets for adequate consideration, even if the transfer is to a family member, establishing the fraud element is exceedingly difficult.

Often, financially distressed debtors are forced to sell their assets, such as in a foreclosure sale or other bargain sales. In such circumstances, assets are frequently sold for less than the hypothetical fair market value. The Supreme Court held that in such circumstances, the consideration received in a forced sale constitutes equivalent value.[16] However, the protection of this Supreme Court ruling applies only when there is an opportunity for competitive bidding. For example, the consideration received in a foreclosure sale will be deemed sufficient only if the sale was open to public bidding.

The use of partnerships becomes of great importance in reducing the amount of acceptable fair market value. Because partnership interests can frequently be discounted for lack of control and lack of marketability, the debtor may be able to sell a partnership interest at a discount, and still satisfy the adequate fair market value test. However, to comply with the above referenced Supreme Court ruling, it may be advisable to disclose the sale in a local newspaper, thus, theoretically, opening the sale of the interest to public bidding.

Under the actual intent test discussed above, both present and future creditors can bring an action to void a transfer. That is not the case under the constructive fraud test. Under this test, only present creditors can challenge the transfer. Future creditors must always establish actual intent, which is generally a lot more difficult than showing that the debtor was insolvent and made a transfer for less than full consideration.

The insolvency situation is the most important one, as it is most frequently applied, and we will start there.

i. Insolvency

The debtor's financial condition, specifically the question of whether the debtor is insolvent, is by far the most important inquiry under the actual intent or the constructive fraud tests. In any asset protection case, this should always be the initial query. It is often recommended that the client's accountant prepare a current balance sheet, on a fair market value (not book) basis.

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[16] In re BFP, 511 U. S. 531, 545 (1994).

While solvency does not mean that the debtor is in the clear to make any transfer, insolvency usually leads directly to a fraudulent transfer finding.

Constructing the debtor's balance sheet is not a straight forward exercise in accounting. The assets must be reflected on the balance at their fair market values, and both assets and liabilities while determined on the date of the transfer, must take certain other factors into account.

Thus, for example, in determining the debtor's assets, anticipated income streams, foreseeable capital sources, and loans must be taken into account. This means that a business must be valued as a going concern, accounting for future anticipated cash flows. Value is usually determined by assuming that the debtor would have a reasonable amount of time to sell his or her assets. Consequently, no liquidation discounts are applied. This is obviously favorable to the debtor who wants to establish his or her solvency.

Because valuations frequent rely on expert testimony, the value of a contemporaneous appraisal cannot be overstressed.

Certain types of assets cannot be taken into account (obviously to the detriment of the debtor trying to establish his or her solvency):

- Exempt assets – such as assets protected by the available state or bankruptcy exemptions (like the homestead exemption), and other unreachable assets, such as when the debtor is a beneficiary of a discretionary or spendthrift trust.
- Assets that are transferred to defraud, hinder or delay a creditor.
- Assets that are outside of the jurisdiction of the court – such as assets located in foreign jurisdictions.
- Assets that have been transferred to entities (partnerships, limited liability companies) must be valued by applying valuation discounts.

Under the UFCA (the predecessor statutes to our current fraudulent transfer laws) liabilities were taken into account on their face value and even frivolous lawsuits served to reduce the debtor's solvency. Under the UFTA and the bankruptcy code, liabilities must be discounted from their face value to reflect the probability that they will mature and accrue. This means that a $10 million lawsuit filed against the debtor, where the debtor has an 80% chance of prevailing, must be reflected on the debtor's balance sheet as a $2 million liability.

While certain contingent liabilities must be accounted for, future liabilities are not taken into account. Thus, as a general rule, liabilities that only have to be footnoted for GAAP are not taken into account, because they are future liabilities.

As a rule of thumb, assets are usually valued from the standpoint of the creditor – what would the creditor realize from these assets. Liabilities are valued from the standpoint of the debtor – what is the debtor expected to pay.

Only present creditors may pursue an action for constructive fraud under the insolvency test. No future or future potential creditor has standing. However, it should be kept in mind that insolvency, with respect to a future creditor, may still be used as a badge of fraud.

ii. Overcoming Insolvency

While not immediately apparent from the language of the California Civil Code, it is not enough for a creditor to show that an insolvent debtor made a transfer for less than full and adequate consideration. There must be some connection between the insolvency and the transfer. Usually, this means that there must be more to these two elements (transfer and insolvency) than their proximity in time.

For example, in Credit Managers Association of South. Cal. v. Federal Co., 629 F. Supp. 175, 184 (1985), a transfer by the debtor for less than full consideration followed shortly by a loss of a big customer and a labor strike that made the debtor insolvent was not fraudulent. The court focused on the fact that the imminent insolvency was not anticipated at the time of the transfer. Thus, an unforeseen event that makes the debtor insolvent may be sufficient to rebut the constructive fraud test.

iii. Businesses with Unreasonably Small Assets

Insolvency is one of three circumstances when a transfer of assets for less than adequate consideration will constitute constructive fraud. Another set of circumstances giving rise to constructive fraud is when the debtor makes a transfer and retains a small amount of assets, and it is foreseeable that such small amount of assets will be insufficient to meet the obligations of the debtor.

This test focuses on companies and not individuals (technically, it may apply to individuals as well, but is rarely applied in practice), and only on those companies that require capital to operate (*i.e*., holding companies are not subject to this test).

This test will protect those creditors who engage in a business transaction with a debtor company that does not retain sufficient assets to pay its liabilities. However, not all transfers will be suspect under this test. This test, unlike the insolvency test, does not focus on the debtor’s balance sheet on a particular date, but looks forward beyond the date of the transfer. The test focuses on the debtor’s continued ability to operate its business, which means that those transfers that do not diminish that ability, can not be voided by a creditor.

For example, if a business engages in a sale and leaseback transaction which reduces its operating costs, that will not be treated as a transfer challengeable under constructive fraud.

Whether or not the business is too thinly capitalized to pay its liabilities as they come due is a question of fact with respect to each specific business. Factors that must be taken into account include the volatility of this particular business (greater volatility requires greater capitalization) and future expansion plans.

As with the insolvency factor, it is important to demonstrate the client’s continued business vitality following a transfer by enlisting the help of client’s accountants and financial advisors.

iv. Incurring Debt beyond Ability to Pay

The third set of circumstances that may trigger constructive fraud on a transfer for less than full and adequate consideration is for debts incurred beyond the debtor's ability to pay.

This test is very similar to the above test, except that it focuses mainly on transfers made by individuals, and not businesses. In practice, the two tests are rarely distinguished, as both focus on a debtor's continued ability to pay its obligations.

The only distinction between the two tests is that the first one, because it relates to companies, focuses on business debts, while the second one, focuses on personal obligations.

4. The "Good Faith" Defense

CCC Section 3439.08 provides that a transfer or an obligation is not voidable under Section 3439.04(a) against a person who took in good faith and for a reasonably equivalent value or against any subsequent transferee or obligee. This means that even if the debtor acted in bad faith and intended to commit actual fraud, the creditor or the bankruptcy trustee will not be able to void the transfer to a person who purchased in "good faith."

In order for a purchaser to be protected from the application of the UFTA under the good faith exemption, the purchaser must (i) take the property in good faith; (ii) take the property without knowledge of fraud on the creditor; and (iii) provide fair consideration in exchange for the property received. Transferees cannot simply rely on what is known or not known to them. They have a duty to investigate, if certain facts put them on notice.

5. Practical Implications of a Fraudulent Transfer

Thoughts of fraudulent transfers induce great fear and trepidation, and they have replaced the boogey man in the closet to scare children into being good. Because of their name, fraudulent transfers are often equated with fraud, and would be transferees visualize dark prison cells and hefty monetary penalties.

However, under California law, if a transfer is fraudulent, that usually means that the creditor can set aside the transfer and proceed after the transferee to recover the transferred asset. A patient files a malpractice suit against Dr. Brown. Dr. Brown promptly transfers his golden scalpel to his uncle, for safe-keeping. The patient-creditor has no connection to the uncle and cannot sue the uncle to recover the scalpel. However, if the creditor proves that the transfer of the scalpel by Dr. Brown to his uncle was a fraudulent transfer, the creditor can set aside the transfer and get the scalpel from the uncle. (If the creditor successfully establishes that a transfer is fraudulent, then the uncle (the transferee) is deemed as holding the transferred property in trust for the creditor.)

Consequently, if a creditor proves that a transfer is fraudulent, that simply makes the transfer ineffective. If the debtor has no means to protect her assets other than to engage in a transfer that may be fraudulent, what is the down-side to the debtor in engaging in such a transfer? In the worst case scenario, the debtor loses her assets, which is exactly the same position she would have been in had she not engaged in the transfer in the first place. But there is a definite upside in engaging in the transfer because there is usually no certainty that a creditor would bring a fraudulent transfer action, that the creditor would then be successful in proving a fraudulent transfer, and then manage to actually recover the asset from the transferee.

This practical implication of a fraudulent transfer is rarely discussed in the asset protection literature. Lawyers should never advise clients to engage in a fraudulent transfer, and knowingly engaging in a fraudulent transfer is certainly unethical. However, because this area of the law is so often unclear, when it cannot be determined with any certainty whether a transfer will be deemed fraudulent, and the debtor is left with no other choices, the debtor should consider taking the more aggressive approach to asset protection planning. Again, what is the downside?[17]

Finally, in some cases debtors can engage in a fraudulent transfer without any recourse by the creditor. For example, as discussed below, a transfer into an ERISA qualified retirement plan cannot be set aside by a creditor even if it is fraudulent. Fraudulent transfer laws are state statutes and are always trumped by the application of federal statutes (ERISA), or state constitutions (Florida and Texas homestead exemptions).

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[17] It should be noted that Section 531of the California Penal Code provides that engaging or assisting in a fraudulent transfer is a misdemeanor. In practice, to the knowledge of this author, this section is never enforced, probably because it may be impossible to prove the required "intent" beyond a reasonable doubt.