



# LENDING AND RESTRUCTURING ALERT DECEMBER 2002

## Due Diligence: What You Learn Before You Lend May Put You at Risk

In a recent decision, a New York bankruptcy court addressed an effort by a committee of unsecured creditors to invalidate, as fraudulent transfers, liens that Chapter 11 debtors granted to their lenders prior to bankruptcy. While the court's decision ultimately favored the lender, a secured lender must beware that unsecured creditors may attempt to have two or more transactions of a borrower "collapsed" i.e., treated as one transaction so as to void the lender's lien as a fraudulent transfer, even though the lender gave the borrower fair consideration.

### What are the Rules?

Generally, a borrower's transfer (such as its grant of a security interest) may be nullified if it (i) received less than reasonably equivalent value for the property transferred and (ii) was insolvent at the time of the transfer, or was rendered insolvent by the transfer. A borrower's series of transactions may be "collapsed" for the purpose of determining whether there has been a fraudulent transfer, even though they were documented as separate transactions, where it appears, based on the parties' intent and knowledge, that the transactions actually comprised a single integrated scheme. For example, courts have collapsed transactions where a debtor exchanges property with another party (e.g., a lender) for fair consideration in one transaction, and then subsequently transfers that consideration to a third party for less than reasonably equivalent value.

To be sure, a lender may extend a loan even if it is aware that the borrower intends to invest the loan proceeds in a speculative venture or use them to repay antecedent debt, so long as the funds are to be used for a legitimate corporate purpose. But the lender is vulnerable if it was intimately involved in the formulation or implementation of an overall plan by which the proceeds of the loan were transferred by the borrower to a third party for less than adequate consideration. If the evidence shows that the lender knew, or should have known, that the ultimate use of the funds would deplete the assets of the initial transferee, a court may treat a series of transactions as one transfer for the purposes of determining whether there has been a fraudulent transfer and strip the lender of its secured status.

### Conclusion

A lender should be mindful of the potential liability that can arise if its borrower transfers loan proceeds for less than reasonably equivalent value and the borrower is insolvent or rendered insolvent by such transfer. A lender may extend financing to a borrower for investment in speculative ventures, to repay antecedent debts, and for other legitimate corporate purposes. But, if during its due diligence a lender discovers information regarding a scheme to channel borrowed funds to a third party for less than reasonably equivalent value, and that the borrower is insolvent or will be rendered insolvent as a result of the transfer, the lender may later find the loan and the subsequent transaction(s) collapsed, and its liens voided as fraudulent transfers.



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