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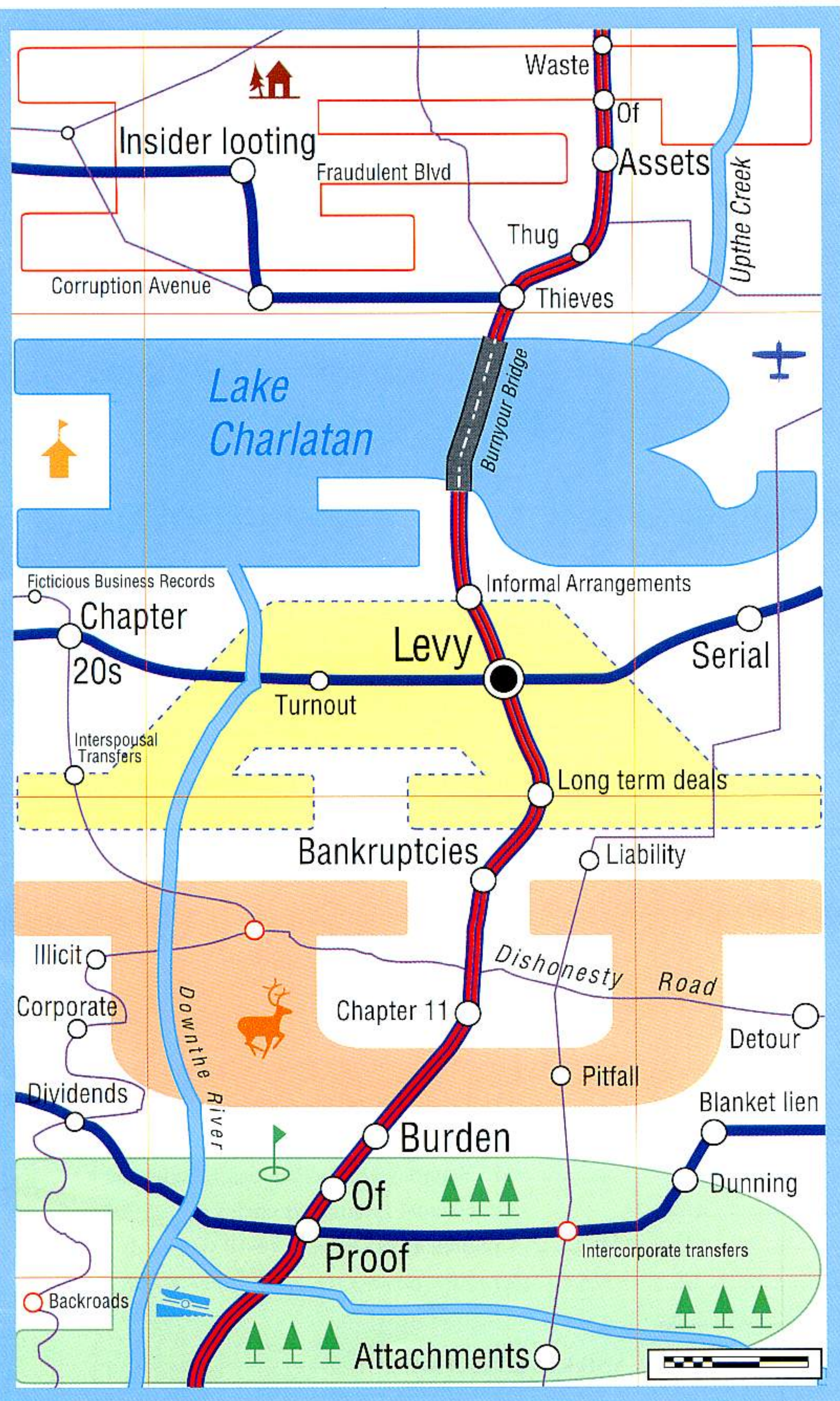

Road map through fraud: Stops, back roads, turnouts and detours

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Road map through fraud: Stops, back roads, turnouts and detours

David J. Cook

Interested in attachments from Afghanistan, bankruptcy from Bulgaria, civil rights from Ceylon, escheat from Estonia, guaranties from the Georgian Republic, levies from Lebanon, preferences from Peru, or replevin from Russia? Or, what about users, suers or abusers right here in the good old U.S.A.? That is what we offer you in this issue—a local tour of thugs, thieves and charlatans, all generically called frauds and fraudulent conveyances.

This excursion takes us through the familiar boulevards of fraudulent conveyances, avenues of corruption, side roads of dishonesty and back roads of theft. Along the way we depict these common, but interesting fact patterns as Stops, with the accompanying Pitfalls, Turnouts, Detours and Back Roads. Although some fact patterns and their solutions slightly overlap, the grand tour furnishes the largest overview in this area of fraudulent conduct.

Stop # 1. Interspousal Transfers and Security Interests

Fred and Mary own a woman's clothing boutique. Operated in her name only, Mary purchases stupendous quantities of wide belts and bell bottoms slacks. Her timing is rotten; the fashion magazines dictate narrow belts and tapered pants. Stuck with gargantuan trade bills for outdated inventory, Mary fields daily telephone calls from collection agencies who, finding no success in dunning, forward the claims to local counsel for suit. From a community bank account, but bearing his name only, Fred lends Mary money to pay about half the trade bills, and Mary executes a note and blanket lien to secure this debt. In the face of the remaining trade bills and ensuing collection actions, Mary perseveres with the business, buys and sells inventory, hires and fires employees and even brings in a small profit.

Upon judgment on the remaining trade bills, counsel installs a sheriff's keeper in the store, which prompts Fred to file a third party claim, asserting a priority through the security interest.

Question: Will the blanket liens fend off the judgment creditor's levy and execution, and why or why not? Does Fred have any exposure for trade bills?

Answer: Probably not. In conveying the bank account funds to Fred, the marital community fraudulently conveys its property to Fred's separate estate. In granting the security interest in the store assets, Mary also fraudulently conveys a community asset to Fred's separate estate.

Through the third party claim, Fred claims priority through the security interest and, if opposed by the creditor, invites the court to examine the bona fides of his lien interest. The burden of proof allocations control fraudulent conveyances cases. For example, Mary is presumed insolvent, if not paying her bills regularly; interspousal transfers suggest fraud; scarce or nonexistence documents for inter-family transfers strongly evidence fraud; a transfer between family members shifts the burden of solvency to the grantee; or family members might bear the affirmative burden to prove consideration and its fair market value. In trying any fraudulent case, counsel moves the court to allocate the burden of proof.

Is Fred liable for the trade bills? Yes, if the business is community and if its income supports Fred. Yes, if Fred is a partner which is evidenced by the bank signature cards naming him as partner, or fictitious business records, city business tax permits, city business licenses, county permits, health permits or sales tax permits listing him as a co-owner.

Is Fred also liable because he has a security interest? No, unless Fred engages in egregious conduct that induces or invites unsecured creditors to extend credit to the debtor who defaults. Additionally, upon receipt of any collection through his security interest, Fred has affirmative *in personam* liability for a fraudulent conveyance.

Pitfalls: Armed with a bogus security interest, conveyees, such as Fred, will file a third party claim that forces the creditor both to proceed with a third party claim, an expensive proposition, and to post a bond to retain the attached property, a more expensive undertaking, which most creditors decline. Even assuming Fred's lien is a total fraud, the third party claim process still succeeds in unhorsing the creditor due to the expense of any viable challenge.

Turnout: Confronted with financial disaster which prompts decisive action, Mary and Fred fraudulently convey their business assets, construct phony liens, and conceal their bank accounts. These events justify an *ex parte writ* of attachment, both to sequester the assets, subject to the suspect conveyance, and the remaining assets, because debtor's course of conduct evidences an intent to conceal, hide and secret.

Most local rules mandate 24 hours notice to the defendant as a condition to any *ex parte* relief, an issue confronting the creditor's attorney. Sometimes, this notice destroys the provisional remedy because notice impels the defendant to dispose of any remaining assets (empty bank accounts) to frustrate the writ process. Justify complete secrecy in the

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writ application through evidence of hatred toward the creditor, such as: "You'll never see a dime." "By the time the sheriff gets here, I'll empty the place." "Sue me, and I'll file bankruptcy." Look for strong evidence of personal dishonesty, centered around the fraudulent conveyance, or complete financial destitution in the debtor's correspondence.

Stop # 2. Restrictive Endorsement Checks, Foreclosures and Waste of Assets for Payment of Non-Corporate Bills

Surviving this attack and instead of waiting for the next disaster, Mary consults an attorney who advises her to incorporate the business. Upon incorporating, Mary transfers the boutique's asset to Mary's Inc. Still indebted to her husband, Mary pledges her shares of stock to Fred as security for the unpaid loan, aside from the blanket lien on the store assets.

Pestered by her pre-incorporation creditors, who drag her into court with Orders of Examination, Mary stocks her incorporated business with highly salable inventory, springs a massive liquidation sale on the public, and sells the inventory to the bare walls. Loaded with ready cash, she pays first the pre-incorporation bills, retires part of her husband's debt, but offers the corporation's creditors pennies on the dollar as full payment, accompanied by correspondence claiming insolvency and intimating a no-assets bankruptcy if the creditors reject the compromise. Mary continues to operate the store. Fending off Mary's personal creditors who levy on the share of stock in his hands, Fred forecloses on the shares of stock by removing Mary's name on the stock certificate and inserting his own without notice to anybody.

Banking Mary's token payment checks, most creditors accept the offer and write off the balance, but a minority of creditors reject the checks, retain counsel and sue. Upon learning of legal action, some accepting creditors even join in the litigation.

Question: Can the creditors (accepting and rejecting) sue and who? Can Fred defend on his pre-incorporation security interest?

Answer: Let us define the claims, first. The corporate creditors have claims against Mary and Fred for a fraudulent conveyance for distributing corporate assets to pay pre-incorporation creditors because they are the ultimate beneficiaries in receiving debt relief. The corporation, and possibly judgment creditors, have additional claims against Mary and Fred for an unlawful dividend, however, general creditors probably lack standing. The court will order repayment of all insider payments, which are unlawful dividends.

To bring apparent legitimacy to the transaction, Mary causes her corporation to assume the pre-incorporation debts. However, the corporation does not receive any equivalent value, rendering the assumption of such debts another fraudulent conveyance itself.

Can the corporate creditors sue the pre-incorporated creditors to return the money? Uncertain, because a subsequent conveyee (pre-incorporated creditors) probably received the money in good faith, but without value. On the other hand the pre-incorporation creditors would claim value because they have a "colorable claim," against the corporation.

Cashing restrictive endorsement checks prejudices the accepting creditors: Commercial Code Section 3311 forces creditors to reject the check or return the money, unless sent to the wrong person in an organization. Section 3311 is a very detailed section.

How's Fred? Doing very poorly. Upon foreclosure of his security interest in the stock, and without notice, Fred probably discharges his entire debt, owed by Mary, and loses his ability to fend off Mary's corporate creditors through his security interest. Furthermore, Fred's security lapses under the four-month rule of Section 9402(7) or evaporates through the consented transfer of the sole proprietorship to the corporation under Section 9306(2). Watch for insider errors in handling their Article 9 security interest.

Turnout: How could rational individuals, such as business people, engage in outlandish conduct to escape a commercial debt? When pressed, business people resort to the grotesque at times. Your job is to reach the assets, which have been transferred, stolen, or retitled. By way of allegory, the collection counsel becomes the shepherd of the debtor's flock of assets, which debtor rapidly depletes by consumption. Don't promise clients too much.

Pitstop: Restrictive endorsement checks are always tough. Judges place the burden of acceptance or rejection upon the creditor. Recently enacted, Commercial Code Section 3311 apparently controls these items, but most states have a large body of case law or alternative statutes that likewise resolve these issues. Watch for a conflict between Section 3311 and existing law.

Stop # 3. Multiple Corporations Operating a Single Enterprise

Taking a tip from the asset protection manuals solicited in the airline magazines, Mary incorporates her business into separate entities; Mary #1 Inc. owns the valuable lease and inventory; Mary #2 Inc. manages the store and administers the cash; Mary #3 Inc. buys products and pays bills with funds available for distribution by Mary # 2. Mary #4 holds the sales tax permit, files the return and pays taxes with available funds. Betting on O.J.'s conviction, Mary stocks the store with a Marcia Clark inspired wardrobe, rather than a Johnny Cochran line of men's ties. Mary bets the ranch and loses. Sensing pending doom in the business, Mary peddles her retail stock to the walls and causes Mary #1 to prepay its rent for months. Mary separately bankrupts Mary #2 through #4 and leaves three bankruptcy trustees with no asset estates, depriving the bankruptcy trustees of any money to finance litigation against Mary #1 Inc. or Mary individually.

Question: Can the creditors sue, whom and on what theory?

Answer: All four corporations jointly operate Mary's business as a single unit and incur liability for all trade bills either under a joint venture theory, agency, or alter ego basis. The concept of joint venture appeals to a trial judge because Mary operates each corporation for the greater purpose of the retail store itself. Smart operators, such as farmers, separately incorporate their general operations (such as sales, inventory, utilities, etc.), but pare off the land, lease, or certain crops into a separate legal entity, which all operate as a joint venture. In short, the joint venture theory binds these different units as one legal entity.

Furthermore, the credit application probably fails to differentiate between these various entities and spawns claims for fraud and negligent misrepresentation for Mary as a signer. Generally, case law mandates that the contracting party insert in the four corners of the document the correct corporate name or imposes personal liability. Mary is also liable on an alter ego theory, along with various fraudulent conveyance claims, and unlawful dividend theories, but subject to proper party standing.

Pitstop: Aside from tax, health, county and related permits to determine ownership, always check Superior, Municipal and Small Claims court records, both Plaintiff and Defendant for the debtor to confirm ownership and legal title to the business. Other collection lawsuits by other creditors probably contain credit applications, contracts and invoices, all evidencing ownership.

Stop # 4. Split Ownership, Insider Looting, Assignments for Benefit of Creditors

Jealous of Mary's growing legal erudition, Fred and Friend in partnership open a combined restaurant, bar and catering business. Hoping to avoid Mary's experience, Fred and Friend quickly incorporate the restaurant and establish food service, utility and liquor accounts for the restaurant, bar and catering business in the corporate name. Bad timing runs in the family, and this new business flounders. Hoping to avoid total financial disaster, Fred and Friend claim that the catering business continued as a separate partnership business, that the corporation erroneously received some catering receipts, and compels the corporation to execute a note in their favor to repay the catering receipts. Days before eviction by the restaurant's landlord, Fred and Friend execute an assignment for the benefit of creditors of the incorporated restaurant business only to the local adjustment house. Also days before the assignment, Fred and Friend additionally cause the corporation to pay the catering note to themselves in full, and interest to date. Fred and Friend individually own, and therefore exclude, the liquor license for the bar business from the assignment.

Overjoyed with the new business, the assignee liquidates the restaurant assets and distributes the proceeds through checks with restrictive boilerplate endorsement ("...discharges claims against the assignor and principals...blah, blah, blah...").

Tipped off by a disgruntled employee, some creditors sue everybody who walks, creeps and crawls.

Question: Who to sue, and why? Does it make a difference that they hold the bar in the name of the partnership, and not the corporation and for which creditors?

Answer: This is a problem of "standing." Probably, but not certainly, the assignee for the benefit of creditors maintains the probable exclusive right to sue for the fraudulent conveyances on the basis that the corporation suffered the loss, and any recovery is shared *pro rata* with the creditors. The corporate note for the alleged catering receipts and its payments to the insiders are two fraudulent conveyances, subject to recovery by the assignee defined as a creditor under the Uniform Fraudulent Conveyance Act.

However, in light of split ownership creditors have a joint venture claim against Fred and Friend, if the bar contributed to the restaurant business, a reasonable assumption, based upon the listing of drinks in the menu or on the restaurant tables. Liquor, soft drink, beverage distributors have a direct claim against Fred and Friend for bar supplies and product, anyway.

Perplexing at best, the assignee's restrictive endorsement checks frustrate creditors in seeking recourse for the obvious theft. The restrictive endorsement benefits the corporate insiders and induces them to proceed with the assignment in the first place as the holy grail of the poor man's bankruptcy discharge. Based on these restrictive endorsements, the assignee is impliedly representing that it has made a complete investigation, and that the creditor's dividend represents the fruits of those efforts, which is a dubious proposition. Probably, the restrictive endorsement means that the assignor (qua debtor) maintains control over the assets, that the assignment is revocable, and that the assets in the hands of the assignee still belong to the debtor and are subject to levy.

Pitstop: Think about prejudgment writs of attachment. Levy upon all furniture, fixtures, equipment along with the persons as potential holders, or custodians of the debtor's property, such as the corporate officers, assignee for the benefit of creditors and spouses. If it moves, attach by levy. Watch for the outer limits of expense and abuse of process.

Stop # 5. More Assignments

Fred and Friend toiled night and day in the restaurant, like dogs, they said. Fred and Friend denied that they ever received a salary. "We worked for love." However, the daily bank deposits only list credit card drafts. Despite this slight anomaly and a very well-healed lifestyle, Fred and Friend demand payment of six figures unpaid wages from the assignee for the benefit of creditors. The assignee's principal, the manager of a local collection agency, forwards the claims to counsel, who instructs the assignee to pay only the priority portion of the claims because the state labor statute provides for a priority wage claim of $2,000.00 if earned within 90 days before the assignment. The assignee rejects the balance of their claims. Fred and Friend threaten suit, but offer to accept 50 percent on the dollar of their total wage claims in exchange for a general release from the creditors.

Some creditors hold personal guaranties against Mary, Fred or Friend.

Question: Will this stick? Are the creditors stuck? Will the guaranties survive this loss?

Answer: This is another long standing problem in which corporate insiders use an assignment, along with either waiver or subordination of their claim, as a platform for a very broad release. The answer is probably that the release will stick as to the consenting creditors, only. Non-consenting creditors will retain their rights against the corporate principals, but might receive either a small *pro rata* dividend, or no dividend at all. The risk is that the assignee embodies the proposal in a detailed letter, which creditors might not understand, and forwards checks with restrictive endorsements, which also might effectively discharge guaranty claims held by an unwary creditor. The better answer is that the accepting creditors are probably stuck with this mediocre deal, along with the non-consenting creditors who probably lack both standing and sufficient financial interest to litigate the claims.

Again, the larger question is whether control by the corporate insiders of the assignee's conduct taints the entire assignment and renders the assignee the insider's agent. If the assignor retains ability to prevent distribution to a non-consenting creditor, the assignee is probably deemed the assignor's (or the insider's) agent and any assets in its hands are subject to levy.

Pitstop: Local insolvency counsel feeds cases to assignees who in turn retain the same attorney on other matters, raising terrible conflict issues. Further, if faced with a case ripe with fraud, assignees only reluctantly, if ever, proceed against the assignor (or its corporate principals) to recover the unlawful taking for fear of scaring off business from the referring attorney. Presume an assignment for the benefit of creditors conceals a fraudulent conveyance, preference, or outright theft, such as skimming cash from the daily proceeds, a difficult, but possible, theft to prove. Bring in the forensic accountant.

Consider a levy on the assignee by garnishment. Many assignments are disingenuous and the assignee is the debtor's agent. Better, levy on the insiders before the assignment that prevents the assignee from bargaining away insiders' claims for an enhanced recovery to the creditors.

Finally, if the creditor has a guaranty claim against insiders, always levy on the assignee to recover their wage, note and return of capital claims.

Stop # 6. Illicit Corporate Dividends while Insolvent, Stolen Customer Checks and Standing

Mary and Fred believe that happiness is found in a family business, so they think. The family that works together stays together. Well counseled, they start a wholesale distribution business under the name of Mary & Fred Inc., a Nevada corporation, which specializes in food service distribution and sells to restaurants and bars. Some people never learn, or bad luck follows them to the grave. Unknown to them, Super-Success Inc., an NYSE traded, infallible distributor, decides to move its modern distribution facility next door to Mary & Fred Inc.'s shop and immediately offers a competing line of products at steeply discounted prices.

Bad enough? Hearing the sirens of Chapter 11, Mary and Fred blame each other for their rapidly declining fortunes, and they part company very abruptly. Mary stays with the company, and Fred abandons the ship but with more than a leaky life raft for financial security. Before the final split, Fred engineers his personal corporate dividend. While Mary is visiting sales prospects, Fred purloins a dozen customer checks, payable to Mary & Fred Inc., properly endorses the checks, and deposits them in his personal bank account (at Bonko Bank). As the only officers, directors, shareholders and managers, Mary and Fred sign on all bank accounts and regularly deposit checks in the company accounts. However, some checks, stolen by Fred, already bore the company endorsements that include the verbage, "for deposit only."

Mary (or more precisely her accountant and divorce lawyer) discovers the theft. A creditor's attorney also discovers the theft and sues. After some time, the bankruptcy lawyer discovers the theft and sues. Everybody is suing.

Question: Who to sue? Who is going to pay, assuming Fred skips out?

Answer: The initial target is Fred's bank, the collecting bank, which accepted the checks for deposit. However, Commercial Code Section 3405 empowers "responsible," employees to affix the payee's endorsement but negotiate the checks on their own behalf and effectively exonerates the collecting bank of some liability. Shortened, the power to endorse is the power to cash. Preventing a total disaster, Section 3405 generally shifts liability to the collecting bank if comparatively negligent in failing to exercise ordinary care. Watch for Commercial Code Section 3307 that imposes liability upon the collecting bank which knowingly accepts a stolen, suspicious or purloined check. Furthermore, Mary & Fred Inc. has a valid claim for all checks endorsed Mary & Fred Inc., For Deposit Only, as to the collection banks under Commercial Code Section 3206. The corporation can sue Fred for the unlawful dividend and fraudulent conveyance, along with breach of fiduciary duty.

Turnout: Remember you did not make this mess. For its own business reasons, the vendor extended credit to virtual criminals. Do your best, and do not sacrifice yourself on the altar of the debtor's fraudulent conduct, or the client's misjudgment. Fred is a bad person and will not settle simply upon demand, suit or even judgment. These are very tough characters. Check criminal records.

Pitstop: Bankruptcy begins to make its appearance. No surprise. Creditors and their lawyers habitually whine about bankruptcy. Counsel always wisely advises clients that "bankruptcy circumscribes your civil rights to collect a debt; bankruptcy serves as the final boundary."

Detour: Proceed promptly with an action against the banks for the converted checks, but watch local state laws to confirm whether the collecting bank or paying banks are liable, but not both. Due to the overlay of comparative negligence, bring an expert who is familiar with checks, deposits and negotiation practices, a very obscure area.

Stop # 7. More Restrictive Endorsement Checks

Alert to the risks of accepting accounts receivable checks, payable to a company, into a personal account, Bonko Bank wisely declines the deposit. Ever so helpful, the tellers suggest that Fred cash the checks at a local check cashing service, which might show great flexibility for a fee.

Unable to find a check cashing service nearby, Fred flies to Las Vegas and cashes the receivable checks at multiple check cashing services. Some checks already bore the payee's endorsement by the company's bookkeeper that includes "For Deposit." Other items were unendorsed when Fred liberated them from the bookkeeper's hands.

Answer: Commercial Code Section 3405 validates certain unauthorized or forged endorsements, and only comparative negligence reallocates the loss. Accepting these items for deposit, as a presumptive holder in due course, the check cashing services, and their banks, are also subject to the standards of Commercial Code Section 3405 and liability for comparative negligence. Also, never assume holder in due course status.

Even if successful against the check cashing services, they lack a bank's financial standing and render collectibility unlikely for any substantial judgment. Both the check cashing service and its bank have almost no defense to checks bearing the restrictive endorsement of "for deposit only." Commercial Code Section 3206, etc.

Stop # 8. Stolen Maker Checks and Negligence

Upon learning of Fred's larcenous behavior and avoiding further losses, Mary instructs Bonko Bank to remove Fred's name from the account card and stop Fred from cashing any customer checks or his own checks against the company account. However, even in her zeal, Mary forgets that Fred had a stash of company checks which he continues to use freely, obviously for non-company purposes. The bank errs and pays $20,000.00 on one hot check and debits the company account, causing a dozen legitimate vendors' checks to bounce, including the rent check. Mary demands the bank re-credit the company's account because the errant item was unauthorized and forged. After a detailed factual investigation and finding that Mary failed to account for all company checks, particularly those checks in the hands of Fred, the bank declines payment.

Question: How could this happen? Isn't the bank strictly liable for paying on a forged maker signature?

Answer: Almost. Only authorized to pay on checks bearing a genuine signature, the bank bears virtual liability under Section 4406, subject to very tight reporting requirements. However,

Commercial Code Section 3406 imbues comparative negligence into the area of forged maker signatures. Under these facts the bank might successfully defend if the trier of fact believes that Mary failed to "exercise ordinary care" which contributed to the making of a forged signature against a person who in good faith takes it for value or for collection.

Stop # 9. Cashing Corporate Checks

Recognizing recent changes in the Commercial Code in the handling of suspicious checks, particularly company checks deposited into personal accounts, Bonko Bank formulates a "do not ask and do not tell" policy. Even if the transaction looks very bad, such as the low level bookkeeper cashing, not depositing, the $1 million dollar company check, allegedly with the company endorsement, the "don't ask" policy may protect the bank from knowingly laundering a bad item. Aware of this policy, Fred cashes a $100,000.00 accounts receivable check, payable to the company. A little out of the ordinary, and in the face of Fred demanding small denominations for $50,000 and traveler's checks for the balance, the teller, somewhat alarmed at the irregularity, asks to confirm Fred's capacity as corporate officer of Mary & Fred Inc. Happily, Fred complies by flashing a business card only, and upon receiving the bag of cash, looks forward to his new homestead, the ultimate depository for this corporate dividend, or repayment of an old corporate loan, depending on the tax consequences.

Question: Is Bonko Bank stuck for this loss? Is being stupid enough for liability under Commercial Code Section 3307? Or does liability flow from an objective standard of stupidity? Does the thief need a plastic, neon or printed sign?

Answer: Has Forest Gump gone to teller school? Commercial Code Section 3307 imposes liability upon the collection bank, check cashing service or conduit, if the taker has notice that they take the check in breach of fiduciary duty, or stated in the vernacular, a "hot check." The court will probably hold that "knowledge," is probably objective, not subjective, hopefully and avoid Forest Gump witticisms, such as "So much money is so heavy." The solution is to instruct bookkeepers to endorse all checks with an endorsement stamp that identifies the depository bank, account number and with "for deposit only." But watch for restrictive endorsement problems under Section 3206.

Stop # 10. Stolen Money and Homesteads

Successful in transforming corporate receipts (the customers' checks) into personal funds, Fred faces the ex-spouse (Mary), the creditors, the bankruptcy estate and banks. Fred keeps about half the money and ploughs the other half into a homestead exemption for a new house.

Outside the 90-day preference window, the creditor files its suit, obtains a writ of attachment against the corporate assets, and levies upon Fred as the custodian (or the trustee) of corporate assets, which are the purloined funds.

The court consolidates the cases, and at trial, Fred interpleads the remaining money. The court faces the creditor, wife and bankruptcy estate.

Question: Who wins this race?

Answer: Let us sort out the spoils. The purloined money taints the homestead exemption in the house because a thief cannot use laundered stolen money through an exemption. The court will impose a constructive trust upon properties acquired with stolen funds. The proper litigant (see below) sets aside the homestead and, assuming sufficient equity in the property, prompts the sale of the property. The creditor proceeds with an equitable action to impose a constructive trust, accompanied by a *lis pendens* upon the property. Think about a receiver to take possession of the property and provide for a prompt sale.

The probable proper party is the attaching creditor who levied upon Fred outside the 90-day preference period. Assuming the typical debt collection against a corporation, along with attaching the bank accounts, inventory and equipment, always serve a garnishment levy upon all corporate officers, shareholders and directors, whose response is uniformly, "Nothing held." Apparently ineffectual at first, these levies seize from the corporate insiders any corporate property held in trust, fraudulently conveyed, or simply just stolen. Always levy by a garnishment opposing counsel who may hold the debtor's money in trust, a large unused retainer, or other items of valuable property for the debtor. Irritating at first, these levies deliver results occasionally.

Pitstop: Looking for supercharged relief? As part of provision relief, turnover orders compel delivery of the property held by third parties, such notes, certificates of note, bank accounts, and physical personal property, to the sheriff. Serve these orders along with the attachment itself. If the garnishee defaults or refuses, proceed with a post attachment Order of Examination, accompanied by an S.D.T. At the hearing on the O.E.X., request a turnover order which, if granted, constitutes an *in rem* judgment.

Turnout: Is this line of work particularly difficult? Starting with credit itself, sales driven wholesalers, financial institutions, newspapers and manufacturers proffer credit as an incentive to induce customers to purchase large quantities of goods and services. In the restaurant industry, for example, customers, facing similar product lines from competing wholesalers, will select the product line accompanied by the easiest credit terms.

In this soup of credit and products, some customers suffer delinquencies, bankruptcies and insolvencies, all obvious to anybody. However, labeling all transactions as commercial credit is a misnomer because sometimes the customer has no intention, nor ability, to repay the credit when due or even past due. In fact the customer defrauded the vendor out of its products (or services). Collection on fraud accounts is difficult, arduous and frequently impossible as the customer perpetrates the fraud in the collection and legal process. Differentiating between a commercial bad debt and a fraud account, counsel should advise the client that the commercial account becomes a bad debt when the credit terms expire (typically 30 to 60 days) and converts into a write-off upon insolvency or bankruptcy. On the other hand, counsel should advise that a fraud debt became a complete write-off when the goods or services left the hands of the vendor.

Answering the question at the beginning of this section, this work is not difficult, but arduous.

Detour: Despite your good effort, the courts regularly deny attachments, much less exotic turnover orders or provisional O.E.X.'s. Some judges simply despise attachments because they believe that attachments bludgeon hapless business people to death. This is true, but don't despair. Try the poor man's attachment; move the court to advance the trial and advance discovery contemporaneously with the attachment. Instead of granting the attachment, the court might advance both the trial and discovery, which exerts pressure upon the defendant to settle or face trial or a paper blizzard.

Another Detour: Let us ratchet up relief to temporary protective orders (T.P.O.) which forbid the debtor to transfer, dispose and alienate assets. Are they useful? Sometimes. If served, T.P.O. encumbers the debtor's property and starts the 90 day preference clock, an advantage *in the* rapidly collapsing universe of the debtor. If in compliance, the T.P.O. conserves the debtor's declining estate. If violated, the creditor proceeds with contempt. (Miranda?) If the attachment is denied, T.P.O. serves as the consolation prize. The five easy rules:

1. Be prepared. Always have the form and bond ready.
2. If Judge Hesitant expresses uncertainty, state the following: "Judge, I'd be happy for a T.P.O. with an order shortening time, if the defendants waive service of the T.P.O., all moving papers, and the T.P.O. is effective NOW, and counsel accepts service on the record of everything. Otherwise, your T.P.O. relief is ineffective without service, a remedy made useless by the defendant's avoidance of service." Judge says, "That seems reasonable. How about it, counsel?" Opposing counsel replies, "Gee, Judge, I don't have the authority." You say, "You mean I'm going to chase down your client?" Response from debtor's counsel: "I guess so." You say, "Judge, the defendants will continue to victimize my people." This colloquium reshapes the attachment hearing for the judge—grant the attachment because the defendants are jerks. Deny the attachment but risk further loss to the plaintiff. This is a risky process because the judge can deny all relief.
3. Provide for the longest possible time frame for the T.P.O.
4. Include "Joe Doe" provisions (tricky) for all corporate officers and agent.
5. Serve as many officers and agents of the defendant as possible.

More Detours: Cross complaints enter the scene. Serve an attachment on a noticed hearing, and the debtor responds with a cross complaint for bad product. Cogitate knockout defenses under notice mandates of Commercial Code Sections 2602(1), 2605(1)(b), 2607(3)(a), 2608(2) and 2609(1) or acceptance (really failure to reject) of Section 2606(1)(b), if not others. The cross complaint precipitates attorney's fees and costs for these defenses. File and serve an amended attachment, seeking these additional fees, costs and expert fees, as part of the larger claim which mushrooms in defense of the bogus cross complaint.

Stop # 11. Serial Bankruptcies

Shortly after the first levy, Fred files a Chapter 13 with just the face sheet, petition and skeleton schedules. In short order the court issues an Order to Show Cause mandating the filing of the balance of the Chapter 13 package. Fred does nothing, and the case is dismissed. Many creditors file claims but fail to follow the proceedings and remain in ignorance for months, or years, about the status of the proceedings.

Fred files a second Chapter 13 through a local attorney and proceeds with a First Meeting of Creditors but dismisses the case before plan confirmation. Fred files a Chapter 7 but fails to appear at the First Meeting of Creditors, leading to another dismissal.

Question: What is the risk involved in these facts?

Answer: Unlike Chapter 11s and 7s, a Chapter 13 debtor may dismiss his or her case virtually upon demand, leading to another Chapter 13. Courts regularly dismiss ill filed Chapter 7s and 11s, which prompts another filing. As a result, creditors regularly receive serial bankruptcy notices. A creditor must file a proof of claim in each proceeding and serial proceedings penalize creditors who fail to read the case numbers carefully. Follow each proceeding to determine whether the case continues. Intending to stall creditors, debtors in *pro per* file skeleton proceedings, which are always dismissed but lack any mailing list which prevents notice of the dismissal to creditors.

Stop # 12. Limited Partnership, Transferring Property to Avoid Creditors

An avid bibliophile, Fred discovers an entire library dedicated to asset preservation. Studying selections that range between legal casebooks and "How to Cheat the IRS" tomes, Fred concludes that asset preservation means reaching the equilibrium in which the property owner changes the status of property (a fancy word for the common word meaning "title") but retains beneficial use of the property. Taking lessons from a more aggressive missive, Fred transfers his home into a limited partnership in which his minor child is the general partner and he is the sole limited partner. This transfer removes the property from Fred's name and precludes attachment and judgment liens from sticking to the property. However, Fred wishes to bump some preexisting judgment and attachment liens and backdates the deed beyond the earliest lien. Fred files suit against the lien holders claiming that they are slandering title and seeks both declaratory relief and monetary damages. The amount of the equity equals or nears the homestead exemption.

Question: Do you any of these lien creditors have a chance of success and how?

Answer: To avoid liens, levies and abstracts, the debtor transfers real property to a limited partnership, a modest legal creation, and invests the minor child as a general partner. The starting point is that this conveyance is fraudulent on its face, but requires that the creditor have the court appoint a guardian *ad litem* to represent the minor child as a general partner. Viewing the transaction as venal, the creditor moves for the appointment of a receiver before more damage is done, a certainty under these facts.

Assuming the receiver sells the property for a creditor, will the proceeds attach to the creditors who recorded liens, post fraudulent conveyance? Recent case law suggests that property reconveyed to the debtor and sold to satisfy his or her debts also picks up post conveyance liens on the theory that the property, conveyed or otherwise, is capable of bearing the liens and levies.

The second part of this question arises when the lien creditor competes with the unrecorded deeds of trust or grant deeds, a common occurrence when the debtor sells the property but wishes to allocate sales proceeds. The rule is that a judgment lien does not have "B.F.P." status and therefore an unrecorded valid deed of trust, mortgage or grant deed has a prior priority. However, the creditor could viably challenge the liens because of a fraudulent conveyance (see burden of proof issues), that the parties to the deed lacked any contemporaneous intent for a conveyance, or that documents are fictitious on their face. Check the credit application, credit reports and financial statement for the purported liability or property as listed. (Probably not.)

Stop # 13. Discharge Actions and Collateral Estoppel

Do you think Fred is going to capitulate? Oh, no. Fred searches for another avenue

to dump off his cottage industry of collection lawsuits, including Mary's claim for her interest in the money, the corporation's suit for embezzlement and the bank's claim for indemnity. Should Fred file personal bankruptcy? Probably. Some of these lawsuits convert to bankruptcy non-dischargeability actions. Fred is facing a dilemma. Low on cash, and short of lawyer buddies with a charitable streak, Fred faces default on these state court lawsuits. Fred settles most cases by stipulated judgments for the debt only. After settling, Fred files a Chapter 7. Fred misses the bank's action for indemnity and suffers a default and default judgment.

Question: Will the stipulated judgments survive the bankruptcy through a discharge action? What about the bank's indemnity judgment?

Answer: Generally the bankruptcy court will use the state court file (complaint, judgment, clerk and reporter's record) in applying collateral estoppel in a discharge proceeding. As one judge said, "one trial is enough."

Generally, the bankruptcy court applies collateral estoppel in both default and stipulated judgment settings. However, if the records do not evidence "fraud," the bankruptcy court tries the case on the non-dischargeability issues. Watch for the 60 day cut off in filing discharge actions. Notice of the bankruptcy is notice of all deadlines.

Pitstop: Watch for useless bankruptcy discharge cases; the debtor is both morally and legally bankrupt and the trustee hopefully took all the non-exempt property. Such advice should not squelch discharge actions, but only prompt counsel to demand and receive retainers and hourly fees to avoid a continuing loss.

Stop # 14. Chapter 20s and Long Term Deals

After retaining competent bankruptcy counsel, Fred settles his discharge action by stipulating to judgment for a total package of less than $250,000.00. After the close of his Chapter 7 case, Fred files Chapter 13 and offers to pay creditors $.50 over five years, no interest. Due to the speedy nature of Chapter 13 confirmations, and the pro-debtor statutory bias, the court confirms the plan.

Question: Will the B.A.P. reverse?

Answer: Not necessarily. Watch for zero percent Chapter 13s and 2 percent Chapter 11s. The debtor may file serial Chapter proceedings, such as a Chapter 7 followed by a Chapter 13, that provide for payment over years of non-dischargeable debt. To confirm the Chapter 13, the debtor must show good faith, that all of the nonexempt assets are dedicated toward nonpayment, and that creditors are receiving the same benefit as under a Chapter 7 liquidation, all constituting a low threshold. Given the overall purpose of debtor rehabilitation, once meeting the burden of proof, the court confirms the debtor's plan. With so limited grounds to oppose a Chapter 13, with its very tight time limits, and the judicial animosity toward plan objections, if only based upon creditor grumbling, the creditor (and the lawyer) promptly must file comprehensive plan objections and proceed to hearing on the objections. If the purpose of the Chapter 13 is to discharge a non-dischargeable debt (fraud, embezzlement, larceny, assault, etc.), present your case as a non-dischargeability action. Memorialize local rules that may mandate that the evidence be received by way of declaration only within "x" days before the hearing date. If the objection is that the creditor is receiving less benefits than under a Chapter 7 liquidation, or the debtor is not devoting a sufficient portion of available income, file and serve admissible evidence such as appraisals, income statements and results from a Section 2004(a) examination, or First Meeting of Creditors.

Turnout: Bankruptcy provides a wonderful haven for the dishonest and corrupt through the super-discharge of Chapter 13s and long term arrangements of Chapter 11s. You might win the collection battle, but lose the bankruptcy war.

Facing this outer boundary of bankruptcy, settle fraud claims at the earliest possible stage at 50 to 75 percent (50 percent is a good average), unless the creditor attached a valuable asset. Clients reward quick but economical successes, rather than long, drawn out dramas in which the outcome is speculative and the price tag grotesque because the client knows that any recovery is "found money."

Stop # 15. Chapter 11

Chapter 11s are wonderful, discovered Mary. If confirmed, the plan of arrangement only pays creditors a recovery if equal or better than a Chapter 7. A plan of arrangement, if unopposed, could release liens, sets aside conveyances and retitles property. Even if opposed aggressively by creditors, some plans release co-debtors and issue a broader form of release to corporate insiders for fraud, preference and outright theft. Some partnership plans even release general partners of their personal liabilities, opposed or otherwise.

Mary's plan reaches the pinnacle of Chapter 11 wizardry. In the plan Mary & Fred Inc. pays creditors $.40/dollars over eight years from net profits only. However, Mary incorporates a successor entity, "Mary's Food Service Co." which buys all of the assets of Mary & Fred Inc. in exchange for the assumption of the net profit plan obligations. The plan further provides that creditors release their claims for fraud, securities violations, personal guaranties, alter ego, fraudulent conveyances, breach of trust, embezzlement, etc., against Mary, Fred and anybody else. Upon confirmation, the debtor transfers the assets to Mary's Food Service Inc. The court only keeps jurisdiction to adjudicate claims and pay professional fees. Mary is appointed the disbursing agent without a bond. The plan does not provide for acceleration upon default.

Question: Can a bankruptcy court confirm this plan? What is wrong here? Can a corporate principal bankrupt a company and buy back the company from the proceeding for virtually nothing?

Answer: Under very limited circumstances the bankruptcy court may discharge a whole host of claims, including third party guaranties, alter ego claims, claims against corporate insiders for preference and fraudulent conveyance claims. Read the disclosure statement and plan very carefully under the "discharge" provisions. The remedies follow:

1. File a request for special notice and insure that all notices are being sent.
2. If possible, sit on the creditors' committee and hound the debtor into submitting a decent plan.
3. Watch all time limits to object to plan and disclosure statement.
4. If the case is dormant for over six months, file a motion to dismiss or convert or for an order compelling the filing of a plan and disclosure statement.

Turnout: Do we detect sour grapes about bankruptcy? The commercial torque in bankruptcy is the pull toward excessive legal involvement in the continuing affairs of a debtor against small dollar claims and the expense of case management. Thirteen magic rules about bankruptcy:

1. File the Proof of Claim upon any

notice. Do not wait for the First Meeting Notice.

2. Notice of the proceeding imparts all bar dates, including an objection of exemptions (30 days), discharge actions (60 days) and claims filing (90 days.) Telephone notice ("What are you doing! I filed bankruptcy two days ago.") is probably sufficient notice.
3. Watch for serial Chapter 13s, which are dismissed sometimes without effective notice.
4. Watch for any skeleton proceedings. About 30 percent of Chapter 11s and 13s are dismissed within 60 days.
5. Compare Proof of Claims case numbers with First Meeting case numbers. Surprise.
6. Review carefully all Section 522(f)(1) motions. Debtors low ball real property values between 15 to 50 percent in order to dump judicial liens.
7. Chapter 11 plans habitually contain broad releases for guarantors, partnerships, endorsers, and co-makers and retitle property. Read carefully.
8. For payment programs in some Chapter 11s, look for "due on default clauses," blanket liens to protect pre-petition creditors, independent disbursing agents, continuing and compensated committee supervision, caps on executive compensation and future expansion, minimum payment plans, monthly payment due dates, and "due on sale" provisions, net asset value and net worth requirements, and the widest distribution of continuing financial information. Don't expect the judge to insert any of these provisions in a plan.
9. Chapter 13 confirmation dates rapidly approach; don't delay.
10. Negotiate preferences quickly.
11. If an appeal, demand that the bankruptcy stay relief, pending the appeal, otherwise "mootness," might doom the case, aside from the merits of the appeal itself, particularly in asset sale cases.
12. Always advise clients, if inclined, to sell only C.O.D. to Chapter 11 debtors; let them independently assume the risk of nonpayment.
13. Memorialize local rules, particularly in adversary and contested proceedings.

Pitstop: Full of deadlines, local procedures, special trial rules and expedited proceedings, bankruptcy unkindly adjudicates a litigant's rights. The advance sheets report each month some disaster befallen the hapless creditor or his attorney. Read carefully "global settlements," disclosure statements, plans of arrangements that contain obscure provisions that unfairly rearrange contractual rights.

Detour: Wish you had studied that treatise on taxes from Turkey after reading this article, judging from Jordan, execution from El Salvador or contempt from Columbia? No? Swift justice not your cup of tea? Tisk, tisk, tisk.

Stop # 16. Living Trusts

Remember Fred? Still troubled by creditors, Fred transfers his assets to a "living trust," the latest rage in asset protection. Recently remarried, Fred names Wife #2 as trustee and designates himself, Wife #2 and their children as beneficiaries. Seeking to shield all assets, Fred even conveys the house into the trust. Fred, however, goofed. In filling out a commercial credit application for his new company venture (incorporated, of course), Fred failed to check the box: "Are any of your assets subject to joint tenancy, a trust, tenants in common or any claim by a third party? If so, please explain." Fred either failed carefully to read the application or omitted the box to avoid alerting the creditor. The vendor demanded that Fred execute the personal guaranty, which Fred happily signed, believing that he was judgment proof and his signature was meaningless under the belief that a fool and his money are soon parted.

The credit sours, and the vendors sue the company and Fred, who contests his signature, claiming a forgery. Prove it, he says. After retaining a very expensive handwriting expert and forensic scientist to confirm the ink for the signature, the creditor upon execution discovers that Fred's bank accounts and home are held in a trust which promptly files a third party claim for all attached property. The signatory of the third party claim is Wife #2.

Question: How do we resolve this problem and levy upon the trust property?

Answer: Transfers to trusts are fraudulent on their face because the trust does not convey anything in return. As the remaining issue, did the transfer render the debtor insolvent (or was the debtor insolvent anyway)?

Aware of the weakness of transfers to trusts, the debtor meanwhile will quickly encumber the property in favor of commercial lenders and either secrets the loan proceeds or acquires additional encumbered property. Once a fraudulent conveyance is found, the creditor should immediately levy upon the property before the debtor recycles the equity through the encumbrance process.

If the property is conveyed to a revocable trust, disregard the trust and immediately levy on the property.

Fred also bears personal liability for fraud. In order to insure complete relief to the creditor, the court deems Fred the agent of the trust, and that Fred impliedly offers the trust property as available assets for execution if listed on the credit application, and imposes a lien upon the trust property.

Turnout: The most feared adversary? Any young attorney who is related by blood to the debtor and working for free or for the experience. Why? With lots of free time, they work the case to death without any economic constraint. Settle before you become a victim of opposing counsel's hobby.

Stop # 17. Prenuptial Agreements and Joint Tenancy

Finding happiness in marriage #2, Mary and Husband #2 sign a prenuptial agreement but leave the date blank. They buy a house together and title the property as joint tenants. Leaving the clothing and food service business and entering the world of computer software by mail, Mary's luck fails again. After a protracted battle with creditors and defending collection suits on the basis that the software product was defective, allegedly torpedoing the business, Mary loses a few actions. After recording liens upon the marital home, some creditors commence the sale process. Husband #2 files a claim asserting that the property, though acquired after marriage, is separate property both due to the pre-nuptial agreement and the title of the property held as joint tenancy. In completing credit applications for some creditors, Mary does not disclose, when asked, the interest of Husband #2 in the marital home.

Question: Can Husband #2 prevail over the creditors?

Answer: Abstracts, liens and levies, again, lack the status of "BFP'" and any preexisting conveyance or liens might bear greater priority. Pre-nuptial agreements that divide property, if valid

and non-fraudulent, could defeat a subsequent execution. Credit applications will ferret out these secret deals with the following language: "Is any of your property, or the property listed here, subject to any claim of joint tenancy, tenants in common, pre-nuptial agreement, trust claim or undisclosed third party claim?" If undisclosed, the creditor claims that the signing spouse was acting as an agent for both spouses, that the failure to disclose the pre-nuptial interest was a fraud, and that both spouses operated as a joint venture, and therefore are both jointly liable and the assets of the joint venture are impressed with the debts.

Stop # 18. Divorce Court Discharging Debts

Mary and Husband #2 did not have a successful marriage. Apparently the strain of their financial problems destroyed their marital bliss. In the divorce, Mary gladly transfers the business, and the bills, to Husband #2. Maybe he can do better, she thinks, and we think. Mary gets the house and remaining possessions. All obligations are deemed community.

Post divorce, a creditor sues Mary on the community obligation. Mary defends, claiming that the court assigned the liability at issue to Husband #2.

Question: Is Mary right?

Answer: Yes. Many states provide that the dissolution judge may allocate community assets and liabilities to one spouse and effectively discharge the other spouse of any liability, even if the creditors lacked complete notice of the proceeding. Unlike bankruptcy, which provides for notice to creditors, divorce courts reallocate assets and discharge some liabilities in virtual secrecy. Dissolution practice almost reaches a sophisticated level where the court may discharge a party of their own separate contractual liability. This area of law is very unpredictable, at best. Run the names of the parties through the computer database to locate any possible divorce filings. Obtain copies of the file and confirm the status of the proceedings. Consider a levy on the property before any transfer, as the pre-transfer levy sticks to the property.

Stop # 19. Conveyances Between Insiders and Corporations

Realizing ex-spouses rarely bequeath gifts, Husband #2 comprehends that he inherited a profitable, but debt-laden business. Instead of bankruptcy or an assignment for benefit of creditors, Husband #2 engineers a bulk transfer to his newly formed corporation (entitled "Successor"). In exchange for the assets, Successor executes a five year, non-interest bearing, unsecured promissory note, for $60,000.00, lacking an acceleration clause, payable to Husband #2. The total amount of business debt exceeds $200,000.00. Conservatively, the assets are worth $150,000.00 without consideration of good will, a considerable factor for a profitable business. Previously Husband #2 held title to the business as a sole proprietorship. To induce the creditors to settle their claims, Successor offers to pay an additional $.15/dollar at the end of the 60 months to creditors who presently agree to accept the escrow dividend in full satisfaction of their claims and release Husband #2. As a further inducement to any reluctant creditor, Husband #2 threatens a personal no-asset bankruptcy unless 90 percent of the creditors accept.

Husband #2 pledges his corporate stock and long term note from Successor to a local bank as security for additional capital.

Question: Are there any rights left for the accepting and non-accepting creditors?

Answer: This is another fraudulent conveyance, but the issues in this case are different. The husband fraudulently conveyed the business to his newly formed corporation because the proceeds (long note) do not represent a fair equivalent exchange, particularly if burdened without an acceleration clause, and the payor is fundamentally the same business enterprise as the husband's sole proprietorship, save the current incarnation into a corporate form. To avoid this absurd stretch out and reduction in the principal amount by 40 percent, the creditor should obtain a pre-judgment writ of attachment and encumber all sole proprietorship property and obtain an injunction in the attachment order against the transfer itself.

Turnout: Pre- and post-judgment remedies, such as attachment, execution and creditor's suit are arcane and technical. Many judges are ex-district attorneys and city attorneys, while some have civil trial experience. Don't be shy: explain the nuts and bolts of all remedies to the judge. Make it simple. Describe the remedy in detail, and wait for the "Okay, I get the picture, where do I sign?" Worry about blank faces. Become animated when the judge mumbles something about harsh remedies that might overwhelm the debtor. If the debtor or judges complain that the attachment might disable the debtor (polite for putting them out of business), respond with the statement, "But judge, the debtor can always bond around attachment, or deposit the money with the sheriff or clerk of this court. Why don't you issue the writ and I'm sure that the debtor will generate the resources to satisfy the writ." At all times, keep a straight face.

Pitstop: Contrary to most civil litigation in which the efforts are "back loaded," at trial, good provision remedy work is purely front-loaded, which means that the injunction, writ of attachment, T.P.O., etc., might resolve the case over a number of days, if not hours. Act quickly.

Stop # 20. Adjustment Agencies, Blanket Liens and Informal Arrangements

Believing in the future of software as the ultimate consumer product, Successor sells massive amounts of all the popular titles and generates both a huge cash flow and mountains of bad debt. Anticipating financial failure, Successor hires the local credit bureau who immediately receives a blanket lien as trustee for all creditors, who are unaware of this largess. Allegedly, in exchange for the security interest, the consenting creditors shall stay collection action. Some creditors forward written acceptance of the security interest.

Seeking quickly to liquidate both old creditors (the 60 month note creditors) and new creditors (new product vendors) and generate a global release, Husband #2 offers new money of $50,000.00 as a dividend that serves as full payment for all claims and retained in trust by the credit bureau. Supported by a creditors' committee, which retains insolvency counsel who recommends the offer, the local credit bureau disseminates Husband #2's offer to the creditors, who generally accept.

Prior to any dividend distribution, and angered by an apparent sham transaction with active participation of the local credit bureau, some creditors file an independent action and attach both monies held by the adjustment bureau and Successor's assets.

Question: Will this action bear any success against the monies held in trust by the credit bureau and Successor's assets?

Answer: The lien granted by the debtor to the adjustment bureau is a fraudulent conveyance and a fraud upon all parties. In granting the security interest to the adjustment bureau, the debtor does not receive any consideration

of equivalent value because the adjustment bureau renders nothing in return. In any case, the creditors have not consented, nor participated in any "blanket lien." Sometimes the adjustment bureau receives the security interest without any creditor participation but offers the security interest to any creditors who choose to forbear from collection action. If the dollar amount of the forbearing creditors is less than the value of the assets, the conveyance is fraudulent. If the agreement does not provide for the right to foreclose, the security agreement is illusory. Most adjustment agreements are also illusory if dependent upon most creditors consenting, or if the debtor and creditors will later reach an arrangement.

The better question is whether the monies held by an adjustment house belong to the creditors or the debtor. If an errant creditor levies upon the adjustment house, who lays a valid claim? If the debtor deposits funds for distribution to creditors, but without an agreement, the funds are held in trust, pending final instructions. Some third party levies both deprive the debtor of any instructions and taint the funds with the garnishment lien. Even if the funds are deposited with instructions for disbursements, absent irrevocability, the garnishment takes priority. On the other hand, if the debtor reaches a binding, final long term payment agreement with its creditor body, and the total creditor pool exceeds the value of the debtor's assets, and subject to irrevocable instructions, the monies might become the creditors upon deposit with the adjustment house. Absent all these conditions, the money still belongs to the debtor and is subject to a garnishment by a creditor.

Stop # 21. Intercorporate Transfers

Currently golf appeals to the baby boomers who voraciously snap up flashy equipment. Unscrupulous as always, Fred through his new corporation (Primoclub Inc.) contracts with an overseas manufacturer to produce his Primo brand but with shoddy materials. Golfing with a Primoclub, Paula, a purchaser, tees offs and swings at the ball, but the club shatters mid swing and gravely injuries Paula by partially blinding her. As plaintiff in a million dollar suit, Paula sues and serves Primoclub Inc., which lacks insurance and defaults. Sensing risk in selling inferior golf products but believing in the potential of recreational products, Fred transfers all assets of Primoclub to Primesport Inc., which sells roller blades and in-line skates. Fred accomplishes the transfer by incorporating Primesport as the new entity (Nevada corporation) and executes a bill of sale in its favor. Fred's new wife is Primesport's sole shareholder whose capital contribution, allegedly originating from separate property, is $50,000.00, which is soon repaid from profits. Plaintiff Paula levies on her judgment against Primoclub without success. To avoid the taint of a fraudulent conveyance, Primesport Inc. issues a 15 year unsecured note for a face value of $250,000, payable upon maturity, interest only payments and no acceleration clause.

Question: Can Paula proceed against Primesport Inc.?

Answer: This is a common fraud. Facing big dollar debts, either from personal injury claims or trade bills, a corporate debtor transfers its assets to a related corporation, conceals the fraud with the long term note as consideration, and uses a nominee as the shareholder. Let's walk through the rights and remedies.

Although Primesport provides some consideration, its large dollar note is economically worthless, and in light of Primoclub's insolvent financial condition, the transfer is fraudulent. The basis of the fraud consideration is inadequate, the transfer is to defraud a tort claimant, or the transfer leaves the transferor without capital. The remedies are that Paula, a judgment creditor, may levy directly on the assets of Primesport, seek a receiver or injunction, or impress a lien upon Primesport's assets for her debt. Furthermore, Primesport violated the Bulk Sales Act because the two corporations, hoping to avoid public notice (and ensuing attachments), failed to publish and record the Notice of Intention or open an escrow, and incurred virtual absolute liability for the predecessor's debts. Also Primoclub suffered a defacto corporate dissolution, failed to provide payment for creditors and effectively conveyed its assets to a new corporation in which Fred is the actual shareholder, if not officer and director. Fred receives the economic benefit of the assets of Primoclub through a new corporate form, and therefore an unlawful dividend subjecting him to probable liability.

A close cousin to alter ego theory, successor corporate liability theory takes center stage, particularly on the dais of a tort claimant. The general rule is that a successor corporation assumes liability for the predecessor as follows: in acquiring the assets without sufficient consideration; the transfer is undertaken to defraud creditors; the successor expressly or impliedly assumes the liabilities; the transaction is a merger or consolidation; or the successor is a mere continuation of the predecessor. The high points of a fraudulent transfer are that the successor failed to provide consideration which constitutes the economic equivalent of the acquired assets, or the consideration is the stock of the successor which is given to the shareholders of the predecessor.

Assuming a non-tainted transfer, the road diverges between a commercial claimant, excluded from any recovery, and a tort claimant, who may assert liability against the successor if the predecessor legitimately closed its doors, foreclosing any probable recovery, and successor played some role in curtailing the creditors' rights. This result strikes the tripartite balance among strict liability, risk exposure, and alienability of assets doctrines and propagates a very contentious body of conflicting case law. On balance the tort claimant probably wins this contest as a very difficult case.

Pitstop: Look for continuity of officers, directors, shareholders, business location, product line, capital structure, vendors, customers or trade names which typically link predecessor to successor. Alter ego concepts affix liability between the two entities, such as inadequate capitalization for both entities, personal use of corporate funds, poorly documented corporate records. Depose the successor's bank; watch for accounts receivable checks and insurance refunds owed to the predecessor deposited in the successor's bank account. Subpoena the successor's vendors for credit applications and financial data, which relate the entities. Confirm whether the successor is current on its note payments; a defaulted note evidences fraud and inadequate capital.

End of the Road

Seen your share of lively characters on our tour? Let us visit home again, which is the traditional commercial practice of suing, serving and taking judgment. Most commercial practitioners follow this path, which is known to debtors and their attorneys, who in response stake out their own and different route to protect the scarce assets. This tour furnishes the dishonest debtor's travel plans and constructs roadblocks through the writ process. Hope you enjoyed the trip.

Gotta go! I have a hearing for a writ of attachment soon.

Good luck and happy trials. □