Fraudulent Transfer Risks in a Portfolio Loan

by Joshua Stein

Lenders like property portfolios. By lending against a group of properties rather than just one property, a lender diversifies the collateral and mitigates the risk that some local aberrational event or market shift might impair the value of a particular property.

Therefore, if a borrower can deliver to a lender a mortgage on a portfolio of properties, the borrower will often obtain more loan proceeds, more flexibility, or other more favorable terms than it could have obtained by financing each property separately. The borrower may also save some transaction costs by closing a single loan for the entire portfolio.

If one entity owns the entire portfolio, the owner can grant a single mortgage on all the properties and the lender can record that mortgage in many recording offices. The entire pool secures the entire loan and no special issues arise of the type discussed here.

Most real estate investors prefer, though, to form a separate entity — typically a limited liability company, sometimes a partnership — to own each property separately. They do this for many good reasons, all beyond the scope of this discussion. The use of separate entities means that no single borrowing entity owns the entire portfolio. Each property owner must deliver its own separate mortgage to secure the entire loan.

Although a multiple-borrower structure makes perfect business sense, it may create some risks for lenders under bankruptcy law and under the law that generally governs the rights of debtors and creditors. This manuscript explains those risks, assesses their magnitude, and discusses some techniques to respond to them. This is intended as a general discussion of these issues in the abstract. For any particular transaction, competent professional advice must be obtained, as the actual details of any particular transaction, and the laws of a particular

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state, may dramatically change the analysis. The reader is cautioned not to rely solely on this manuscript for any particular transaction.

For convenience, this manuscript will use the following terms. Each "Property Owner" owns a single "Property" and delivers a "Property-Specific Mortgage" to the "Lender." The aggregate financing is the "Portfolio Loan."

The credit and collateral structure of a Portfolio Loan can be summarized as follows. The Portfolio Loan is a single loan, cross-collateralized and cross-defaulted. Each Property Owner is fully liable for the entire Portfolio Loan, but usually only on a nonrecourse basis, *i.e.*, its liability is limited to the possible loss of its Property. Depending on the borrower's agenda, each Property Owner will often have a different general partner and different limited partners. The same ultimate parent(s) would own and control the Property Owners or, at least, their general partner(s). (For "general partner," one can substitute "managing member." For "limited partner," one can substitute "passive member.")

The use of multiple Property Owners can create problems for a Lender if a single Property Owner ends up in bankruptcy, or otherwise suffers financial problems that lead its unsecured creditors to look for ways to improve their positions. The first thing any unsecured creditor will do under these circumstances will be to scrutinize Property Owner's secured debt and try to convince a court to convert a secured loan into an unsecured one or invalidate it entirely. The mere threat of doing so can increase the leverage that might be applied against Lender.

While this hypothetical may seem unlikely, it does describe one risk that can actually hit. And protection from precisely this risk — the risk of being an unsecured creditor — is a principal reason why any lender takes security for a loan. If under any circumstance a "secured" loan ultimately might not stay secured, then the "security" exercise may have failed to achieve its fundamental purpose.

Other creditors are not the only parties who might try to set aside Lender's security or to obtain leverage by threatening to do so. If any Property Owner goes into bankruptcy, that Property Owner's own management — the principals of the borrowing group — could threaten to try to set aside the Property-Specific Mortgage or the bankruptcy trustee might try to raise the issue.

The use of multiple Property Owners can create problems for a Lender if a single Property Owner files or involuntarily ends up in bankruptcy, or otherwise suffers financial problems that lead its unsecured creditors to look for ways to improve their positions. The first thing any unsecured creditor will do under these circumstances will be to scrutinize Property Owner's secured debt and try to convince a court to convert a secured loan into an unsecured one or invalidate it entirely. The mere threat of doing so can increase the leverage that might be applied against Lender.

The theory for setting aside any Property-Specific Mortgage would proceed from the perspective of any bankrupt or financially distressed Property Owner as follows. When that Property Owner signed on to the Portfolio Loan, it incurred debt that far exceeded both a). the value of Property Owner's assets (the Property) at that particular moment; and b). the benefits Property Owner received from the transaction. In other words, Property Owner "got ripped off." And, in legal parlance, the transaction might be deemed a "fraudulent transfer."

WHAT CONSTITUTES A "FRAUDULENT TRANSFER"?

In a bankruptcy or a state law "fraudulent transfer" proceeding affecting just one Property Owner, a court might look closely at transactions like this one. If the court concludes that the transaction made the particular Property Owner "insolvent" without providing "fair consideration" or "reasonably equivalent value" to that Property Owner, then the court might decide the Property-Specific Mortgage legally constituted a fraudulent transfer. And courts have the power to set aside any fraudulent transfer.

In deciding whether a Property-Specific Mortgage is a fraudulent transfer, the court might not consider the benefits of the Portfolio Loan to the borrowing group as a whole. Although as a real-world credit matter, Lender makes the Portfolio Loan to the entire borrowing group, a court might very well decide to conduct a separate fraudulent transfer analysis for each Property Owner. (This assumes the multiple Property Owners are not

substantively consolidated in bankruptcy, a possibility discussed below.)

A court will typically evaluate Property Owner's solvency based on a balance sheet analysis — a comparison of assets vs. liabilities. In the alternative, a court could find a fraudulent transfer if it decides that a Property Owner did not receive fair consideration or reasonably equivalent value and at the time of the Portfolio Loan closing was unable to pay its debts or had "unreasonably small capital" given the nature of its anticipated business. The court would perform this analysis with the benefit of 20/20 hindsight at a moment when (presumably) Property Owner is in financial distress. If the court finds "insolvency" but no "fair consideration" or "reasonably equivalent value" to Property Owner, the court might set aside the Site-Specific Mortgage or some or all of Property Owner's liability for the Portfolio Loan.

The outcome of the "fraudulent transfer" analysis of this transaction is by no means hopeless for Lender.

For example, a court sympathetic to Lender might say that if Lender forecloses on a Property-Specific Mortgage and forces one Property Owner to pay the entire Portfolio Loan, then that Property Owner would have a legal right to require the other Property Owners to contribute their shares of the Portfolio Loan. This legal right of each Property Owner is called a "contribution right."

The court could attach a value to a Property Owner's contribution right. The court could then say that the value of the contribution right represents an asset that balances out Property Owner's possible liability for the entire Portfolio Loan; therefore the Portfolio Loan did not make Property Owner insolvent; therefore the Portfolio Loan was not a fraudulent transfer at all.

A court might also recognize that in the real world, a Lender will almost certainly enforce the Portfolio Loan against all Property Owners at once, rather than just single-out a lone, hapless Property Owner as victim. Based on that practicality, the court might discount the prospective liability of any one Property Owner.

Although supported by some of the decided cases, neither a discount for contribution rights nor a discount for improbability is uniformly accepted. A court trying to rescue only a single distressed Property Owner from its financial plight might instead compare the assets and liabilities of that particular Property Owner; decide Property Owner's new liabilities (the Portfolio Loan) overwhelmed Property Owner's assets; and conclude that Property Owner became insolvent as a result. While this outcome is possible, Lender could certainly argue that it would be improper.

The definition of a "fraudulent transfer" leaves plenty of discretion to the judge. In applying the "fair consideration" or "reasonably equivalent value" tests, courts can be skeptical of indirect or secondary benefits that allegedly accrued to an insolvent borrower. If the other "fraudulent transfer" tests were met, the court might invalidate and set aside a Property-Specific Mortgage. In that case, Lender would become, at best, an unsecured creditor and, at worst, might find that some or all of the Portfolio Loan could not be enforced against the particular Property Owner.

Lenders can add language and structural elements to their loan documents to reduce the "fraudulent transfer" risk in several ways. How far to go depends on the particular Lender's concern about the particular borrower group and the marketplace at the time — *i.e.*, whether the next lender down the street would be willing to overlook this risk and save the borrower some attorneys' fees and potentially some risk. The following discussion summarizes some steps a Lender might take to mitigate the "fraudulent transfer" risk in transactions of this type.

1). *Liability Limitation* - The loan documents can limit each Property Owner's liability for the Portfolio Loan to the maximum amount of liability that Property Owner can bear without becoming insolvent. Provisions of this type are common in corporate loans guaranteed by all the subsidiaries in a group of companies. They should reduce, but do not necessarily eliminate, the "fraudulent transfer" risk. A court bent on invalidating a Property-Specific Mortgage might decide the liability limitations are self-serving and formalistic and do not alter the underlying substance of the Portfolio Loan. Lender and its counsel would, of course, disagree. The court might also decide that the liability limitations, as written, did not limit liability enough to fully prevent insolvency.

2). *Effect of Nonrecourse Clause* - Because the Portfolio Loan is nonrecourse for each Property Owner, such Property Owner will, by definition, normally have no meaningful liability or exposure for the

Portfolio Loan beyond the value of its interest in its Property. Each Property Owner's liability is automatically limited, in most cases, to (the value of) its Property. Regardless of how much nominal "liability" any Property Owner appears to have assumed for the Portfolio Loan, that liability is meaningless to the extent it exceeds the value of the Property. A Lender can therefore reasonably argue that, by definition, the Portfolio Loan could not possibly have rendered any Property Owner "insolvent."

That argument may, however, suffer the same judicial response as the liability limitations discussed above. Moreover, bankruptcy would introduce another layer of uncertainty and complexity, because for purposes of Chapter 11 reorganizations, a "nonrecourse" claim will often automatically become a "recourse" claim. But even so, if Property Owner is a single-purpose entity that has only one asset, the Property, totally encumbered by the Property-Specific Mortgage, how can one say Property Owner has any meaningful liability beyond the value of the Property? The answer may depend, in part, on the nature and magnitude of the entity's other creditors (if any).

3). ***Formal Contribution Agreement*** - All Property Owners can enter into a formal contribution and indemnity agreement. This agreement could be built into the loan documentation or stand alone. Either way, it would amount to a mutual aid pact among Property Owners. If any one Property Owner ever paid more than its share of the Portfolio Loan, it could look to the other Property Owners for help on an equitable basis. This agreement would try to give each Property Owner an identifiable and formal "contingent asset" to balance out the "contingent liability" created by potentially disproportionate liability for the Portfolio Loan.

A contribution and indemnity agreement could help prevent insolvency of any individual Property Owner. It would do this by having all Property Owners acknowledge, formalize, and strengthen whatever informal contribution rights they would otherwise have among themselves. The value of this approach depends, in part, on the value of the reimbursement claims among Property Owners.

A mutual-aid agreement probably further diminishes the "fraudulent transfer" risk, but may not eliminate it. In addition, any reimbursement rights among Property Owners would need to be subordinate to Lender's Loan and could raise other issues. And, if the entire group of Property Owners becomes insolvent in the aggregate, the mutual aid pact will not help.

4). ***Structuring and Disbursement*** - When Lender documents and disburses the Portfolio Loan, Lender can try to demonstrate on paper why a court should allocate the Portfolio Loan among the various Property Owners and not treat it as a huge liability that overwhelms the assets of any individual Property Owner. For example, Lender can:

- Disburse the Portfolio Loan in pieces to the various Property Owners, in recognition that courts have invalidated loans where the lender could not show that the loan proceeds were disbursed to the actual borrower.
- Require the various Property Owners to execute separate notes evidencing their shares of the Portfolio Loan. Each note would be secured by a first mortgage executed by the corresponding Property Owner. Then each Property Owner would grant a second mortgage to secure only the entire Portfolio Loan except the part represented by the specific Property Owner's individual promissory note.
- Establish a record to show that the parties agree and believe in good faith that when the Portfolio Loan is considered and reasonably allocated as a whole, each individual Property Owner remains solvent.

Although these documentation and disbursement measures may help, they may be less likely to help prevent or diminish "fraudulent transfer" problems than the measures previously described.

5). ***Indemnity to Lender*** - All Property Owners and their partners (and other affiliates?) can indemnify Lender against any fraudulent transfer risks that might affect any one Property Owner. These indemnities could be secured by all the mortgages on all the Properties, as well as by pledges of all the equity in the deal. Although this arrangement does not provide any meaningful credit enhancement to protect against the fraudulent transfer risk, it does at least make it hard for any borrower affiliate to use the "fraudulent transfer" argument against Lender selectively, for any particular Property.

In deciding whether to require equity pledges, though, a Lender needs to remember that this security device raises its own issues and concerns, primarily relating to the reliability of the security package and what a lender can realistically do if the Portfolio Loan ever goes into default. Also, the equity pledges might themselves be subject to fraudulent transfer attack, depending on the overall ownership structure of the equity owners.

6). ***Global Bankruptcy*** - If any one Property Owner

were subjected to bankruptcy proceedings or a "fraudulent transfer" action, the circumstances would probably have already allowed Lender to declare a default on the entire Portfolio Loan, against all the Property Owners. Lender might go a step further and say in the loan documents that commencement of any fraudulent transfer proceedings against any Property Owner would automatically allow Lender to accelerate the Portfolio Loan. Any such acceleration would, in all likelihood, force all other Property Owners into bankruptcy proceedings, if they were not already.

Lender might prefer a single global bankruptcy for all Property Owners as opposed to separate "fraudulent transfer" actions affecting each Property Owner. In a global bankruptcy, the court might treat the assets and liabilities of all Property Owners as if they were assets and liabilities of one entity — a "substantive consolidation." This would support a single-entity fraudulent transfer analysis that would probably benefit Lender by tending to validate the entire structure. Moreover, based on how particular Property Owners conducted their affairs, the particular facts might provide further basis for substantive consolidation.

Substantive consolidation is, however, a rather flexible and unpredictable legal doctrine. How and when to apply it depends very much on the discretion of the particular bankruptcy judge. It would depend on the particular facts and the positions taken by the unsecured creditors in the case.

In the typical real estate bankruptcy proceeding, a secured creditor will oppose substantive consolidation, but the special facts of a Portfolio Loan might lead a Lender to favor it — at least in dealing with Property Owners that obtained the Portfolio Loan. A Lender might not be as enthusiastic about bringing other unrelated affiliates into the bankruptcy proceeding. While a court might be receptive to Lender's position, it might also conclude that a Lender cannot assert it after having dealt with the separate Property Owners as separate entities. Finally, if all the Property Owners are insolvent when considered as a group, Lender might disfavor substantive consolidation.

7). *Common General Partner* - Lender might insist that Property Owners restructure their internal ownership to assure that all Property Owners are general partnerships and they all have the same general partner, with the general partner having recourse liability for the entire Portfolio Loan. That general partner would therefore already be liable for all debts and obligations of every Property Owner, including the Portfolio Loan. It could pay that liability from any of its assets, including its partnership interests in all Property Owners.

If not paid, Lender could always proceed against that common general partner, directly, in its capacity as general partner of all Property Owners, without having to consider issues that arose because the general partner had somehow assumed liability for some other entity's indebtedness. In a typical case, the use of a common general partner would substantially diminish whatever incremental "fraudulent transfer" concerns might arise from cross-collateralization with separate Property Owners.

A borrower may resist the use of a common general partner or single entity to hold all assets. A borrower might express concern that such a structure would be inconsistent with its business needs and desires, and would make it incur significant transaction costs and probably tax exposures.

8). *Guaranty* - An upper-tier, deep-pocket entity might execute a narrow and limited guaranty, designed to protect Lender only against the risk that any Property Owner's obligations or Property-Specific Mortgage were ever invalidated based on fraudulent transfer theories.

As an alternative, such a guaranty might be even more narrow, applying only if Property Owner's management, through skillful manipulation of the bankruptcy process (and its control of the "debtor-in-possession") ever tried to invalidate any Property-Specific Mortgage on fraudulent transfer grounds. Such a guaranty would give higher-level ownership an incentive to prevent any Property Owner from manipulating the bankruptcy process to Lender's detriment.

As long as the ownership used its control in a way that did not hurt Lender, the guaranty would

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never trigger. Thus, Lender would continue to bear whatever risks might arise from any fraudulent transfer actions that other creditors (e.g. trade creditors, slip-and-fall plaintiffs, and environmental claimants) might take to set aside the Property-Specific Mortgages. An upper-tier guaranty would, however, give some protection against bad faith on the part of the very parties most likely to exercise it — Property Owner's management.

A guaranty of this type should raise few legal issues or problems of its own, such as questions about its validity. And if the borrowing group is proceeding in good faith, it is hard to see how the borrowing group can make any good arguments for not giving such a guaranty, other than general aversion to contingent obligations and personal liability of any kind.

9). *Purchase Agreement* - As a variation on the theme, Lender might request that some higher-level entity agree to purchase the Portfolio Loan at par (plus a prepayment fee) from Lender if anyone ever tries to invalidate any Property-Specific Mortgage as a fraudulent transfer. An obligation to purchase the Portfolio Loan would eliminate potential issues about measurement of Lender's damages and hence about the amount of Lender's claim under a limited guaranty – but perhaps raise issues about whether the arrangement is really a guaranty after all.

If a Lender adopts some or all of the deal structures suggested above, this should significantly diminish the likelihood that Property Owner's management could use the bankruptcy and fraudulent transfer process as a creative technique to leverage Lender. A borrower's reaction to any of these structures might include the following arguments:

- This is a nonrecourse loan without any credit enhancement, period, paragraph.
- Assuming a multi-branch ownership structure, no branch of ownership can control another. (Lender would respond that these branches can and should, without much trouble, negotiate appropriate covenants and internal indemnities. Lender would be happy to help all ownership branches solve their "internal imbalance" problem by obtaining the same good-guy guaranty from all branches. Lender might even agree to allocations of liability rather than joint and several liability. And, if the branches of ownership are not comfortable enough with one another to stand shoulder-to-shoulder on this type of risk, Lender may legitimately ask larger questions about the group as a whole.)
- There is no single upper-level entity that indirectly has the benefit of all the equity in all the assets and thus is an appropriate guarantor.
- No upper-tier entity in any branch of ownership is otherwise interested in assuming any potential exposure for any of these risks.
- The rest of the world closes multi-property, multi-borrower secured loans without worrying about these problems, or by adopting only some of the measures suggested above — and, in particular, does not require guaranties to address this issue. (But, is this really true? . . .)

How far these arguments will go may depend on such considerations as how badly Lender wants to make the Portfolio Loan; whether the borrower has other financing sources; and how the borrower would behave under stress (considering the borrower's possible obligations to third-party investors that might preclude the borrower from behaving reasonably). Also, some of the structures suggested above might incur significant extra transaction costs (e.g., a doubling of the number of mortgages), and these costs might be regarded as excessive compared against the likely risk being addressed.

As a reasonable middle ground, Lender might settle for: a). limitations on the liability of each Property Owner; b). some form of simple contribution agreement; and/or perhaps c). equity pledges. As noted, these three measures do not eliminate the issue, but should diminish it.

Finally, Lender might simply decide that given the large number of things that need to go wrong and the number of arguments that need to fail for Lender to suffer any loss as a result of the risks described in this manuscript, Lender might decide to treat this risk as background noise — the functional equivalent of the risk of being run over by a bus if one decides to cross the street. This would, of course, be a business decision that should first reflect an understanding of the risk, which this manuscript has attempted to provide. That business risk would need to be analyzed in light of the overall financial strength of the parties and whatever level of financial pressure the transaction itself will create, *i.e.*, whether the overall loan-to-value ratio is 45 percent or 90 percent.

The real issue might not be the size of the risk, but rather who should bear it. Why should this problem be Lender's risk at all, even if it is very small? REI