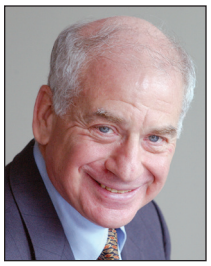
By Jonathan M. Landers and Michael J. Riela

Actual-Intent Fraudulent Transfers and the Crime/Fraud Exception



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Although the attorney/client privilege and the work-product doctrine are the bulwarks of due process and the adversary system, they are subject to exceptions such as the "crime/fraud" exception, which provides that communications made in furtherance of a crime or fraud are subject to disclosure. Recent cases suggest that the "fraud" that may trigger the exception may not be limited to crimes and serious frauds, but rather may include transactions exhibiting only some "badges of fraud."

The Crime/Fraud Exception

The attorney/client privilege protects confidential communications from disclosure that are made between attorneys and clients for the purpose of obtaining or providing legal advice. The work-product doctrine protects materials prepared for, or in the process of preparing for, litigation. Although these communications might be relevant to the litigated dispute, they are protected from discovery to encourage full and frank communication between attorneys and their clients, and to enable attorneys to prepare cases without fear of disclosure to adversaries.[1] However, the crime/fraud exception ensures that the attorney/client relationship is not used to facilitate wrongful conduct.[2]

While application of the crime/fraud exception to clearly fraudulent acts can be straightforward, it is much more difficult to apply it to transactions where the fraud is not inherent in the transaction itself, such as in a leveraged buyout or recapitalization transaction or a merger. What showing must a party seeking discovery of privileged communications make, especially for a transaction that is not on its face wrongful?

The party seeking to defeat the attorney/client privilege must make a *prima facie* showing that (1) the client was committing or intending to commit a fraud that falls within the crime/fraud exception and (2) the communications were in furtherance of that alleged fraud.[3] Courts of appeals do not all agree on what quantum of proof is necessary to make this *prima facie* showing, but several have held that the crime/fraud exception can be triggered when there is a reasonable basis to suspect that the client was committing or intending to commit a crime or fraud, and that the attorney/client communication or attorney work product was used in furtherance of the alleged crime or fraud.[4]

However, there is very little law applying these concepts to fraudulent transfers. The line between actual-intent fraudulent transfers and constructive fraudulent transfers is not clear, and plaintiffs often allege both. It is also not clear whether all actual-intent fraudulent transfers can give rise to the crime/fraud exception.

Some History

Fraudulent conveyance law originated in the Statute of Elizabeth in 1571, a criminal statute that made all conveyances with the intent to "delay, hinder or defraud creditors" a crime. It is difficult to demonstrate the existence of actual fraudulent intent because a defendant rarely admits to nefarious purposes. Thus, courts permitted creditors to employ the so-called "badges of fraud," which were evidentiary indicators of actual intent as a substitute.

The Uniform Fraudulent Conveyance Act (UFCA) divided actual-intent fraudulent conveyances from constructive fraudulent conveyances, and codified the various common law presumptions of actual fraud. However, there was an undistributed middle in the UFCA involving the intent to "delay" or "hinder" creditors where there was no clear malevolent intent. Courts sometimes permitted the use of the badges of fraud to establish actual intent in such circumstances. So the following question arises: Can a plaintiff use the crime/fraud exception in alleged actual-intent cases and employ the badges of fraud to establish ill intent? As discussed below, the answer might be "yes."

1 *See Upjohn Co. v. U.S.*, 449 U.S. 383, 389 (1981).

2 *See, e.g., In re Grand Jury Subpoena*, 419 F.3d 329, 343 (5th Cir. 2005). The crime/fraud exception is generally applied only to attorney/client communications regarding *ongoing or future* wrongdoing, not to communications regarding *prior* wrongdoing.

3 The First, Second, Third, Sixth and Ninth Circuits require probable cause or a reasonable basis to suspect or believe that a client was committing or intending to commit a crime or fraud and that the attorney/client communications were used in furtherance of the alleged crime or fraud. *See In re Grand Jury Proceedings*, 417 F.3d 18, 23 (1st Cir. 2005); *United States v. Jacobs*, 117 F.3d 82, 87 (2d Cir. 1997); *In re Grand Jury*, 705 F.3d 133, 151 (3d Cir. 2012); *United States v. Collis*, 128 F.3d 313, 321 (6th Cir. 1997); *In re Grand Jury Proceedings*, 87 F.3d 377, 381 (9th Cir. 1996). The Fifth and Seventh Circuits require evidence that is sufficient to compel the party that is asserting the privilege to come forward with an explanation for the evidence offered against the privilege. *See United States v. Boender*, 649 F.3d 650, 655-56 (7th Cir. 2011); *In re Grand Jury Subpoena*, 419 F.3d 329, 336 (5th Cir. 2005). Meanwhile, the Fourth, Eleventh and D.C. Circuits require a showing of evidence that, if believed by a trier of fact, would establish that some violation was ongoing or about to be committed and that the attorney/client communications were used in furtherance of that scheme. *See In re Grand Jury Proceedings #5 Empanelled January 28, 2004*, 401 F.3d 247, 251 (4th Cir. 2005); *In re Grand Jury Investigation*, 842 F.2d 1223, 1226-27 (11th Cir. 1987); *In re Grand Jury*, 475 F.3d 1299, 1305 (D.C. Cir. 2007).

4 *See, e.g., In re Grand Jury*, 705 F.3d at 153-54 (3d Cir. 2012).

The *Husky* Case

Husky Int'l Electronics Inc. v. Ritz[5] arose in the dischargeability context, where the U.S. Supreme Court held that the phrase "actual fraud," as used in the discharge exception for debts obtained by actual fraud (§ 523(a)(2)(A) of the Bankruptcy Code), encompasses forms of fraud that can be effected without a false representation. In that case, Husky International Electronics Inc. sold products to Chrysalis Manufacturing Corp. on credit. The debtor, Daniel Lee Ritz, Jr., was a director and significant shareholder of Chrysalis. Unbeknownst to Husky, Ritz drained Chrysalis's assets by transferring large sums of Chrysalis's funds to other entities that Ritz controlled, and when Husky found out, it sought to hold Ritz personally responsible for Chrysalis's debt to Husky. Ritz then filed an individual chapter 7 petition, and Husky subsequently contended that Ritz's debt to Husky was nondischargeable because the asset transfers from Chrysalis constituted "actual fraud" under § 523(a)(2)(A)'s exception to discharge.

The Fifth Circuit held that a necessary element of "actual fraud" under § 523(a)(2)(A) is a misrepresentation by the debtor to the creditor.[6] The Supreme Court reversed, noting that although the pre-1978 Bankruptcy Act prohibited only the discharge of debts obtained by "false pretenses or false representations," Congress subsequently added "actual fraud" to that list when it enacted the Bankruptcy Code, and the new "actual fraud" prong of the statue did not require a false representation. But, importantly for these purposes, the Court examined the historical meaning of the phrase "actual fraud" and noted that it was difficult to define "fraud" precisely. It concluded that in bankruptcy practice, the term "fraud" "describes a debtor's transfer of assets that ... impairs a creditor's ability to collect the debt."[7] The Court noted that unlike fraud inducing an extension of credit, fraudulent conveyances typically involve various transfers and the wrongful conduct is an "act of concealment and hindrance."

The *Fragin* Case

In *Fragin v. First Funds Holdings LLC*,[8] Gary Fragin commenced an action in New York State court against Leonard Mezei (his investment advisor), a law firm that represented Mezei and entities that were allegedly controlled by Mezei. Fragin alleged that certain defendants had engaged in an actual-intent fraudulent transfer of assets under New York state law from the entities that had been obligated to pay Fragin.[9] Fragin also asserted that the law firm advised the defendants with respect to the fraudulent transfers, and that therefore the law firm was aware of (and assisted in) the defendants' alleged misconduct. During discovery, Fragin moved to compel the law firm to produce documents relating to the transactions, and sought to compel two attorneys from the firm to respond to deposition questions regarding the asset transfers. The law firm refused, invoking the attorney/client privilege and the work-product doctrine.

The line between actual-intent fraudulent transfers and constructive fraudulent transfers is not clear, and plaintiffs often allege both. It is also not clear whether all actual-intent fraudulent transfers can give rise to the crime/fraud exception.

The state court noted that a party seeking to invoke the crime/fraud exception must demonstrate a factual basis for a showing of probable cause to believe that (1) a fraud or crime has been committed and (2) the communications in question were in furtherance of the fraud or crime.[10] After reviewing some of the privileged documents *in camera*, the court found that both requirements were satisfied.

First, the court held that Fragin offered adequate facts to show that there had been an actual-intent fraudulent transfer based on the existence of a few badges of fraud. In particular, the court concluded that the following badges of fraud existed: (1) a close relationship among the parties to the alleged fraudulent-transfer transaction; (2) the transferor's knowledge of the creditor's claim and the inability to pay it; and (3) a lack of consideration in exchange for the transfer.[11]

Second, the court concluded that the privileged documents contained communications made in furtherance of the alleged actual-intent fraudulent transfer. Although the court also did not conclude that the law firm knowingly participated in the allegedly fraudulent conduct, it was only necessary that the firm had performed legal services at the defendants' behest.

Where Are We?

Will any actual-intent fraudulent transfer satisfy the crime/fraud exception? Must the fraudulent conveyance involve an element of criminal or common law fraud, misrepresentation or concealment, or egregious misconduct? A strong argument can be made that "actual fraud" under § 523(a)(2)(A) means the same as "actual intent" under § 548(a)(1)(A) or under state law. Significantly, the *Husky* Court stated that the test it articulated "incorporate[d] a fraudulent conveyance" and involved "concealment and hindrance," and also approved the use of the "badges of fraud" concept in an actual-intent situation. *Husky*'s language speaks broadly of its application to bankruptcy and refers specifically to fraudulent conveyances.

Both *Husky* and *Fragin* involve a more traditional intentional fraudulent transfer whereby the debtor transferred assets in order to avoid payment of a debt and an individual principal of the debtor allegedly caused the transfers. There

5 _____ U.S. _____, 136 S. Ct. 1581, 194 L. Ed. 2d 655 (2016).
6 *See In re Ritz*, 787 F.3d 312, 316 (5th Cir. 2015).
7 *See Husky*, 136 S. Ct. at 1586-88.
8 2016 N.Y. Slip Op. 31537(U), 2016 WL 4256984 (Sup Ct., N.Y. County Aug. 11, 2016).
9 New York Debtor and Creditor Law § 276 provides, "Every conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors, is fraudulent as to both present and future creditors." This action did not involve a bankruptcy proceeding, so § 548 of the Bankruptcy Code did not apply.
10 *See Fragin*, 2016 WL 4256984 at *3.
11 *Id.*

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is less authority for applying the crime/fraud exception to a negotiated transaction or one not involving a specific avoidance motive.

Several recent decisions are consistent with the Court's reading of "actual fraud" in *Husky* and *Fragin* as applied to such a situation. One is *Lyondell*,[12] where the court concluded that allegations of actual intent in a leveraged buyout case could rest on the intent of the debtor's CEO if that person was in a position to control the disposition of the debtor's property. Another is *Sentinel*,[13] where the court found that actual intent was demonstrated, even though it acknowledged that the debtor did not intend to render funds permanently unavailable to clients. Courts in earlier cases have held that the crime/fraud exception may apply to fraudulent transfers.[14]

Future Considerations

In light of these cases, there is a real possibility that the crime/fraud exception will be applied to communications in negotiated transactions that have a strongly detrimental effect on creditors and are made in furtherance of alleged actual-intent fraudulent transfers. This might be the case even if the client/transferor did not make any misrepresentations to any party, and even if the client/transferor lacks the intent to defraud its creditors. As demonstrated by the *Fragin* case, all that might be required is the presence of one or more badges of fraud. Courts likely will have to grapple with this issue in the near future. An official committee recently moved to compel the production of privileged documents regarding alleged actual-intent fraudulent transfers in the *Caesars Entertainment Operating Co. Inc.* chapter 11 case, citing the crime/fraud exception. Questions for courts to consider in the future may include the following:

- What quantum of evidence is required to support a conclusion that a transaction constitutes an actual-intent fraudulent transfer for the purpose of invoking the crime/fraud exception? The *Fragin* and *Vereen* courts determined that the presence of several "badges of fraud" was sufficient.
- Could the crime/fraud exception apply if there is evidence that the debtor made a transfer only with the intent to hinder or delay, but not necessarily to defraud, creditors?
- Both *Husky* and *Fragin* involved possible veil-piercing or alter-ego situations where a principal caused the debtor to make the fraudulent transfers at issue. However, most companies are not dominated by a single individual or small group of individuals. What evidence of fraud is necessary to invoke the crime/fraud exception when an alleged actual-intent fraudulent transfer is made by an entity that is managed by a board of directors or group of executives?
- Is the standard for invading the privilege under the crime/fraud exception the same if a plaintiff alleges the tort of aiding and abetting a fraudulent transfer?
- As previously discussed, there is considerable uncertainty as to the prerequisites for invading the crime/fraud exception in an actual-intent fraudulent transfer claim involving a corporate transaction (*i.e.*, facilitating the fraud, and cause and effect), and not involving clear intent to harm creditors. There are also issues of whether specific documents must be identified.
- There might be conflict-of-law questions, especially if the fraudulent transfer claim is asserted under state law. The existence of a choice-of-law provision in the documents might also be relevant.

Conclusion

The use of the crime/fraud exception to obtain discovery in cases of actual-intent fraudulent conveyances is still in its infancy. Bankruptcy lawyers should take note. abi

12 *In re Lyondell Chem. Co.*, 503 B.R. 348, 386-88 (Bankr. S.D.N.Y. 2014), *abrogated on other grounds*, *In re Tribune Co. Fraudulent Transfer Litig.*, 818 F.3d 98 (2d Cir. 2016).
13 *In re Sentinel Mgmt. Grp. Inc.*, 728 F.3d 660, 667 (7th Cir. 2013).
14 *See, e.g., In re Andrews*, 186 B.R. 219, 222 (Bankr. E.D. Va. 1995) (involving objection to debtor's chapter 7 discharge pursuant to § 727(a)(2)(A)); *Galaxy CSI LLC v. Galaxy Computer Servs. Inc.*, No. 04-CV-00007, 2004 WL 3661433 (E.D. Va. March 31, 2004); *In re Vereen*, No. 96-78369, 1999 WL 33485642 (Bankr. D.S.C. Sept. 7, 1999).