

Creditor Protection Mechanism of Debtor's Fraudulent Transfer: Comparing Current Legislation of China and the United States

Yixin Li^{1, a, *}

¹*Law School, Shenzhen University, Xueyuan Avenue, Shenzhen, China*
a. 2020031165@email.szu.edu.cn

**corresponding author*

Abstract: Fraudulent transfer behavior refers to the act of a debtor, in order to evade debt, obstructing or delaying the creditor's realization of their creditor's rights by transferring their own property or establishing a right burden on the property. This concept is originated from the Anglo-American legal system, but similar concepts can also be found in Chinese law system. The fundamental reason why fraudulent transfer behavior needs to be regulated is that it violates the debtor's moral obligations of integrity and fairness towards creditors. Based on a comparative analysis of existing rules in China and the United States from the exercise of the right of avoidance to determination that the assignment is invalid, this article proposes a possible approach to fraudulent transfer rules in China in mainly three aspects: improving the definition of fraudulent transfer, providing creditors with more adequate remedies, and adjusting the burden of proof for creditors to exercise avoidance rights.

Keywords: fraudulent transfer, debt avoidance, creditor protection, creditor revocation rights, Union Fraudulent Transfer Act

1. Introduction

The famous *Twyne's Case*, known as the first recorded decision, that articulated the fraudulent badges, is an advanced step of the legislation development in chattel security, especially in fraudulent transfers. In this case, *Pierce* (the main person involved in the case) has a debt with a person named "C". When the sheriff asked *Pierce* to execute its debt with C, he claimed that all his property (mainly some sheep) had been sold and give to another person called *Twyne* to repay the debt between him and *Twyne*. In a word, *Pierce* didn't have any sheep or money, so C's debt cannot be repaid by any means. The panel of three judges invalidated *Pierce's* deed, for the reason that his transfer act to *Twyne* had signs of fraud. This case led the Anglo-American law system to determine that the sale and guarantee of immovable property possession constituted fraud for a long period of time, so as to avoid the third party mistakenly believing that the possessor had "false ownership", thus trading with it and endangering the transaction security. The standard of the identifying fraudulent transfer established in this case is an essential part of legislation of anti-fraudulent transfers in Anglo-American law system. After the landmark *Twyne* case, the development of anti-fraudulent transfer legislation has also experienced a long period. By 1918, the relevant laws in the United States were still inconsistent with each other, with the British Elizabethan Act 13 was still its main legal basis.

Until 1918, the Uniform Fraudulent Conveyance Act was passed, and after nearly 70 years of application, it was amended and renamed the Uniform Fraudulent Transfer Act (UFTA) in 1984. The United States "Uniform Fraudulent Transfer Law" is a complete law, which has been tested by long time of practice, and has reference significance for China's current stage of the protection of creditors from fraudulent transfers. There are some problems in the provisions of China's Contract Law on the creditor protection, such as limited scope of application, inadequate relief measures, and improper distribution of the burden of proof for the creditor's revocatory right. Therefore, it is urgent to learn from the United States Uniform Fraudulent Transfer Act, so as to create a better trading market while protecting creditors.

2. The Concept of Fraudulent Transfer

According to the National Conference of Commissioners on Uniform Voidable Transactions Act, any transfer of property by the debtor in order to evade, delay and deceive the creditor is illegal and invalid. The concept of fraudulent transfer was first developed in the Elizabeth Act of 1750, of which the current system of regulating fraudulent transfer law in the United States has been developed on the basis.

In China, fraudulent transfer is not a common concept, but it does not mean that China does not attach importance to the protection of creditors' interests. In fact, there are many concepts in China's legal system that are similar to fraudulent transfer, such as "the debtor transfers and conceals property to avoid debts".

3. The Remedies Provided by the Chinese Legal System for Creditors

3.1. Remedies in Chinese Civil Law

The remedies given to creditors in Chinese civil law can be divided into two types: giving creditors the right of revocation and determining the invalidity of legal acts. The right of revocation of creditors is the most similar rule to the remedies in the United States Uniform Fraudulent Transfer Act.

The object of revocation right is the unreasonable disposition of property by the debtor, that is, fraudulent transfer. The revocable claim must be established before the fraudulent transfer occurs. However, there are also exceptions. When the likelihood of a creditor's right occurring is high, a debtor who disposes of his or her property in advance in order to avoid future performance of the debt can still constitute fraud [1]. However, at present, the civil code only includes the following actions for creditors to revoke transfer of property without compensation, transfer of property at an obviously unreasonable low price, and waiver of matured claims, which are very narrow in scope. In practice, it is obviously not enough to rely solely on the civil code and relevant judicial interpretations to define fraudulent transfer, relying on the subjective evidence of judges, but the scope of recognition is still limited.

Meanwhile, the debtor's fraudulent transfer needs to cause damage to the creditor's rights. If the debtor's transfer behavior causes its liability property to be insufficient to pay off the creditor, it should be recognized that the transfer behavior is harmful to the creditor's rights. This view emphasizes that the judgment of fraudulent transfer should not ignore the subjective malice of the debtor. Article 539 of the Civil Code does not make a clear requirement on whether the debtor is malicious or not, but the mainstream scholars believe that the elements for exercising the right of revocatory are that the debtor has the malice to evade the debt[1]. In the process of judicial practice, most courts also believe that the conditions for the exercise of the revocatory right need to include subjective malice, but the requirements for the proof are not strict. As long as it can be determined that the debtor's behavior will damage the creditor's rights when it acts, it is presumed that the debtor

has subjective malice [2]. But creditors can provide evidence to the contrary to rebut this presumption [1]. After the creditor exercises the right of revocatory, on the one hand, the debtor's transfer becomes invalid, and on the other hand, the creditor can request the assignee to return the acquired property to the debtor [3].

Another remedy is to determine that the legal act is invalid, with malicious collusion rule as its core. According to Article 154 of the Civil Code, if the debtor makes a false declaration of intention with a third party to avoid the debt, makes up the debt, makes up the guarantee or transfers or conceals the property by other means, the creditor can claim that the debtor's act is invalid. The elements of malicious collusion can be analyzed from subjective and objective aspects. Subjectively, the actor is required to know or should know that his behavior will harm the interests of others, and the actor is also required to have the intention to harm others [4]. The actors conspire with each other, but the contract is based on the true expression of intention. In terms of objective elements, the malicious collusion of the actors will cause damage to the creditors' interests. The Supreme People's Court believes that the subjective "malicious" element of the malicious collusion rule can be comprehensively judged in combination with various subjective and objective circumstances related to the case. For example, the Supreme People's Court held in Guiding Case No. 33 that, based on the fact that "the debtor transferred its main property to its affiliated company at an obviously unreasonable low price, and the affiliated company did not actually pay the consideration while knowing that the debtor was in debt," it could be determined that the debtor and its affiliated company constituted malicious collusion, harming the interests of the creditor. This is a judgment based on objective facts such as the subject matter of the contract, the agreed price, performance, and the relationship between the parties. Based on the association between the debtor and the assignee, it can be presumed that the assignee is aware of the debtor's debt situation, while combining the unreasonable consideration of the transfer behavior, it can be further presumed that the assignee has subjective intent when entering into a contract with the debtor to conduct transactions, which is malicious collusion [5]. Compared with the creditor's revocatory right system, the malicious collusion rule requires a higher degree of subjective malice of the actor, so the scope of application will also be narrower.

3.2. Remedies for Creditors in Bankruptcy Law

The right of revocatory in the bankruptcy law is generally similar to the revocatory right mentioned above, but due to the particularity of the bankruptcy procedure, the cancellation right in the bankruptcy law also requires that the debtor's property is not sufficient to pay off all debts, so as to realize the fair repayment of all creditors.

The scope of acts that can be revoked in the bankruptcy law abide by the principle of legality, only acts that are clearly prescribed in the law can be revoked. The Chinese Bankruptcy Law adopts the enumerative approach, and the revocable actions are limited to the transfer of property without compensation, the transaction at an obviously unreasonable price, the provision of property guarantee for debts without property guarantee, the early repayment of undue debts, and the abandonment of creditor's rights as stipulated in Article 31 of the Bankruptcy Law. In addition, the exercise of the right of revocatory does not require the debtor's subjective malice or not, but only needs to prove that the debtor has several prescribed revocable acts.

4. The Creditor Protection System in the Fraudulent Transfer Act of the United States

4.1. The Highlight of United States Creditor Protection System: Uniform Fraudulent Transfer Act

In the American creditor protection system, the Uniform Fraudulent Transfer Act is undoubtedly the core of the whole system. The Uniform Fraudulent Transfer Act, as a long-standing and systematically designated law specifically targeting in fraudulent transfer practices, has referential significance worldwide.

The purpose of this legislation is to regulate the respective responsibility of each party in the situation of creditors claiming fraudulent transfers by debtors. The legal effects it seeks are in following three aspects: To begin with, providing legal protection for creditors to deny fraudulent transfer behavior; Secondly, weakening the possibility of malicious transferees or insiders in obtaining ownership of the transferred property; Third, effectively reduce the fraudulent transfer of property by debtors. The first purpose expands the relief of creditors and provides more relief methods for creditors. In addition, when the Uniform Fraudulent Transfer Act conflicts with other legal provisions that are beneficial to the debtor, generally, it will be priority than over other laws and provide protection for creditors. The Uniform Fraudulent Transfer Law provides basic legal rules and standards for distinguishing between normal commercial property transfer behavior and fraudulent transfer behavior between parties [6].

4.2. How Does UFTA Protect the Creditors?

To protect creditors from fraudulent transfer, determining the concept and definition of fraudulent transfer is a prerequisite for everything. According to Uniform Fraudulent Transfer Act, it clarifies the concept of "transfer" in Article 1(a)(12). "Transfer" refers to the direct or indirect, absolute or conditional, active or passive disposal of assets or the benefits of assets, including the making, leasing, and release of monetary payments, liens, or other obstructive rights. This type of transfer is not limited to the payment of traditional property (like cash or immovable properties), but rather includes in the transfer any actions that may cause difficulties for creditors to exercise their claims through expanded interpretation. In short, this transfer is actually a disposition of assets. Compared to the former UFCA, a large number of case laws under the provisions of UFTA have expanded and restricted the definition of fraud, with the concept of fraud is no longer limited to deceiving creditors. Any disguised fraudulent behaviour such as intentionally obstructing the realization of asset transfers by creditors will be considered fraudulent.

The Uniform Fraudulent Transfer Act also divides the fraudulent transfer of property by a debtor into pure fraud (factual fraud) and presumptive fraud. Pure fraud refers to the transfer of property or the incurrence of obligations by a debtor for the purpose of impeding, delaying, or deceiving creditors.

The identification of factual fraud mainly refers to the subjective intent of the debtor to directly defraud the creditor. However, in practical situations, it is difficult to prove the subjective psychological state of the debtor [7]. Therefore, according to UFTA§4(b)(1)-(11), there are 11 signs including which is referred to above as "suspected fraud": the transfer or obligation was to an insider; the debtor retained possession or control of the property transferred after the transfer; the transfer or obligation was disclosed or concealed; before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit; the transfer was of substantially all the debtor's assets; the debtor absconded; the debtor removed or concealed assets; the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred; the debtor was insolvent or became insolvent shortly after the transfer was made

or the obligation was incurred; the transfer occurred shortly before or shortly after a substantial debt was incurred; and the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor. These suspected frauds can assist creditors in their subjective and intentional burden of proof against the debtor. When determining whether the debtor is fraudulent, the court will take these factors into account to assess all relevant situations involving defective transfers or debts, and judge whether the act is indeed necessary to be "stifled" [8]. As mentioned earlier, preventing fraudulent transfers is not to prevent such behaviour itself, but to protect the realization of creditors' rights. Therefore, it is not necessary to be restricted by UFTA as long as there is fraudulent transfer behaviour, only if there are evidence that the creditor has suffered harm should it necessary to be prevented. The clear case of this point must be *Lumpkins v. McPhee*, 59N.M. 442,286 P.2d 299(1955). In this case, although the transfer of all assets showed fraudulence, if all the consideration was paid and the transferor transferred possession, then the transfer is not considered fraudulent.

As for presumptive fraud, according to Article 4 (a)(2) and Article 5 of the UFTA, as long as certain objective elements are present, fraud can be presumed to be established without the need to prove the true intention of the debtor's fraud [9]. The situation of presumptive fraud are follows: Firstly, on the basis that the transfer did not receive a fair and reasonable price, the debtor's participation or imminent involvement in a business or transaction made the debtor's remaining property unreasonably small in the associated business or transaction, or was intended to incur, or was recognized as having sufficient reason to believe that he intended to incur, debts that he was unable to repay when due. Second, the transfer of property when insolvent, which are shown as follows: If the debtor fails to receive a fair and reasonable price when making an assignment or incurring a debt, and the debtor has become bankrupt or is about to become bankrupt due to this assignment or debt, then the debtor's conduct is considered fraudulent; or if the transfer is made to an insider's previous debt, and the debtor has become bankrupt at that time, and the insider has reasonable grounds to believe that the debtor has become bankrupt, the transfer is considered fraudulent. In the process of identifying constructive fraud, it is important to determine whether the price of the debtor's transferred property is within the "fair and reasonable" price range. However, it is obviously difficult to establish a fixed standard to determine whether the transaction price is fair and reasonable. Only a few common cases can be identified, requiring flexible application by judges.

In addition to rigorously defining and identifying fraudulent transfers, the advantage of UFTA is that it provides creditors with adequate remedies. The right to relief plays a protective role of "the last barrier" for the realization of creditors' rights. Unlike the single protection with right of revocation in the Chinese Civil Code, Article 7 of the UFTA provides comprehensive and detailed provisions on the remedies for creditors, not only providing for the right of revocation as the primary remedy for creditors, but also granting creditors the right to seize or take other interim measures, the right to prohibit the retransfer of property, and the appointment of a bankruptcy administrator to manage property rights, as well as the joint and several recourse rights of the transferee and any other sub transferee, as well as any relief rights required by the environment [10]. A large part of these provisions is inherited from the old Uniform Fraudulent Conveyance Act and have been continuously accumulated and improved as time goes.

However, this does not mean that creditors should be given unlimited protection. The exercise of many remedies requires strict procedural restriction [9]. The clear case of this point is that in Article 7(a)(2), it is stated that creditors can, in accordance with the procedures prescribed by other relevant laws, seize or take other temporary relief measures against a fraudulent transferred property or other property of the transferee. Article 7(a)(3) stipulates that the provisions of the creditor's remedies are subject to the existing principles of fairness and consistent with the existing rules of civil procedure. The creditor may request the court to make an injunction against the future disposal of the transferred

assets or other property, appoint a receiver to be responsible for the transferred assets or other transferee's property, or any other relief measures that may be required. It can be seen that temporary relief measures such as detention must be within a certain limit, subject to the mandatory restrictions of the due process provisions of the United States Constitution.

5. Transplantation of the Creditor Protection System in the Uniform Fraudulent Transfer Law

There are undoubtedly some problems with China's existing creditor protection system. If we can learn from UFTA and transplant its outstanding provisions into China's creditor protection system, it is necessary to formulate a so-called "Anti Corporate Fraud Transfer Regulations" based on reference to the UFTA and the latest development of case law. The main improvements should include the following:

5.1. The Scope of Application of the Cancellation Right in China's Creditor Protection System is Limited

As mentioned above, UFTA's definition of "transfer" covers all possible areas, giving judges full discretion in hearing cases, making the revocation system more practical. So far, China has mainly adopted enumerationism for revocable situations, which means that specific provisions are made for revocable situations in a clear enumeration manner rather than general terms. The problem caused by this is that the terms are difficult to deal with the ever-changing corporate fraudulent practices.

UFTA first provides a general definition of transfer behavior, and then classifies fraud, identifying actions that reduce responsible property and impede the realization of claims as revocable actions. Taking the *Dories Debt* case as an example, if a company replaces its assets that are easily liquidated with poorer assets and impedes the realization of creditors' claims, it may also be considered fraudulent. Such a definition almost covers the current and even future situations in the operation stage and can well implement the important significance of corporate asset credit for creditor protection. By learning the UFTA definition of fraudulent transfer, the protection of creditors is supposed to be strengthened by this way in China.

5.2. The Creditor Relief Measures in China's Creditor Protection System are Insufficient

Chinese creditor protection system can learn from the relevant provisions of the Uniform Fraud Transfer Law on creditor relief measures instead of only focusing on the simple right of revocation. It is expected to clearly stipulate that creditors not only have the right of revocation, but also can enjoy the right of asking for attachment, as well as the right to take necessary measures against other properties of the assignee. In the case that the assignee cannot control the debtor's property, necessary measures can be taken against other properties of the assignee and add more other ways to realize the interests of creditors.

5.3. Improper Allocation of the Burden of Proof for Creditors to Exercise Their Cancellation Rights

China's creditor protection system does not provide for the burden of proof for exercising the right of revocation, but directly applies the general provisions of civil litigation, that is, who claims, who provides evidence. Not to mention that the Chinese Civil Code does not clearly stipulate the conditions under which the revocation right can be exercised, resulting in situations such as inability to adjudicate in the same case and difficulty in adducing evidence in practice. In UFTA, as mentioned above, fraudulent transfers are divided into actual and presumed situations, and the scope of both

cases is specifically defined. The classified allocation of the burden of proof by UFTA is more conducive to the realization of creditors' rights and interests.

6. Conclusion

UFTA is a law with research value and reference significance. Starting with a clear definition of fraudulent transfer, fraud is classified into substantive fraud and presumptive fraud, and different regulatory measures are provided for different fraudulent acts. Among them, for substantive fraud, the subjective malice of the debtor is difficult to prove, so 11 "fraud suspects" have been proposed based on the first two relevant fraud laws: the Elizabeth 13 Act and the Uniform Fraud Transactions Act. However, these suspects cannot directly determine the truth of fraud, but serve as a basis. On this basis, the court will consider both all negative signs and situations that indicate fraud, and comprehensively determine whether the act is fraudulent. This is a very valuable way to identify fraudulent transfer behaviour that is worth learning and learning from. For presumptive fraud, as long as certain objective factors are present, it can be determined that a fraudulent transfer is tenable without proof of subjective intent. The proposed use of "fair and reasonable" instead of "fair" to describe consideration is of considerable progressive significance. The provision that priority transfers by insiders become invalid when insiders know or should know that the debtor is bankrupt also proposes a new form of fraudulent transfer, providing more comprehensive regulations for the protection of creditors.

It can be seen from the UFTA's protection system for creditors that providing very detailed protection measures not only protects the interests of creditors, but also restricts their power to prevent creditors from abusing their litigation rights and eventually reducing the vitality of the market. China's economic market is now in a process of progress that has not yet been well-developed. It is inevitable that problems will emerge one after another. It is a necessary process to take a broad view of the world and absorb the essence of ideas that have been precipitated from the years of development of various countries with an open and modest attitude.

References

- [1] Shiyuan Han. (2018) *General Theory of Contract Law (Fourth Edition)*, Law Press, 2018 Edition.
- [2] Xiu Yin. (2014) *On the Judicial Application of the Creditor Avoidance System*, in *Studies in Private Law* (Vol. 15), Law Press.
- [3] Shaowei Mao. (2018) *Malicious Collusion, Creditor's Right of Avoidance and Legal Consequences of Contract Invalidation - Commentary on the Substantive Law of Supreme People's Court Guiding Case No. 33*. *Contemporary Law*, 2, 14-25.
- [4] Daixiong Yang. (2014) *The Legislative Trade-offs of Malicious Collusion: A Perspective on the Relationship between Malicious Collusion, Derogatory Acts and Conspiracy to Misrepresent*. *Comparative Law Research*, 4.
- [5] Supreme People's Court Case Guidance Work Office, Fourth Division of Civil Trial Court. (2015) *The Understanding and Reference of "Swiss Cargill International Inc. v. Fujian Jinshi Oil Manufacturing Co. Ltd. and Other Disputes on Confirmation of Contract Invalidation" - Invalidation of Malicious Traditional Debt Evasion*. *People's Justice*, 18, 8-11.
- [6] White R. (1991) *Leveraged buyouts and fraudulent conveyance laws under the bankruptcy code-Like oil and water, they just don't mix*. [1991] (01) *Annual Survey of American Law*, 1, 357-432.
- [7] Jay D. (2004) *Three-Step/Four Test Analysis of the Uniform Fraudulent Transfers Act (Draft)*. Retrieved from <http://www.assetprotectionbook.com/ufta-3-4.pdf>.
- [8] Peter A.A., Luther M. D. and J.R. (1985) *A Critical A-nalysis of The New Uniform Fraudulent Transfer Act*. *University of Illinois Law Review*, 527.
- [9] Markell B. (1988) *Toward true and plain dealing: A theory of fraudulent transfers involving unreasonably small capita*. *Indiana Law Review*, 21,2.
- [10] White R. (1991) *Leveraged buyouts and fraudulent conveyance laws under the bankruptcy code-Like oil and water, they just don't mix*. *Annual Survey of American Law*, 01.