DECEMBER 2016

BUSINESS LAW TODAY

A New Look At Fraudulent Transfer Liability In High Risk Transactions

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Overheard, *in late 2015*, at a very upscale restaurant in New York City:

Hedgie Funde: We have this great LBO opportunity . . . should make four or five times our money in two or three years! But some of my guys are freaked out about legal risk.

John Bull: Not to worry. Worst case, it will cost you a few bucks for lawyers, other pros, and creditors, but it shouldn't be much.

Hedgie: But all that litigation . . . seems to go on forever! Looks like a feeding frenzy by lawyers and their friends. And, look at cases like *Energy Transfer* and *Caesars*.

John: Has nothing to do with your situation. In both cases, there was lots of greed and a short-circuiting of orderly process. You know the old saying—pigs get fat and hogs get slaughtered.

Hedgie: Seems to me like all the litigation starts with big numbers and lots of noise.

John: It does, but things calm down. Look, I'll explain it in simple terms. You stand to make 400 percent in two years. You don't do that in two years without some risk. Instead, you do it mostly with other people's money—you borrow money to pay off the stockholders, use the assets of the company as collateral, put up a few bucks of your own to show good faith, and run the business for a couple of years; and then, you sell out most of your investment. The banks are dying to make these loans.

Hedgie: But, what if we don't make it and a bankruptcy is filed? Won't lots of folks come after us, and won't the judge do something for creditors?

John: Here's the good part. The courts don't like this kind of litigation, and lots of cases support the folks who did the deal. The chance you'll have to pay lots of money is very small, and the risks go down if the company makes it for at least two years. Of course, you've really got to have your ducks in a row when you do the deal, and get lots of expert opinions. You've got to have lawyers who know how to play the game; and you've got to have a team fully prepared to go if the worst happens. Real world risk in dollars is lots less than the upside. But, your pros have to be the best.

Hedgie: And, I assume that means you.

John: C'est la vie.

* * *

This article explores the history that led to that conversation, and whether anything has changed in the year since that conversation took place.

Leveraged buyouts (LBOs) and leveraged recaps (LRs) are high risk transactions for a business (i.e., the target) and its creditors. The LBO adds debt to the target to facilitate the purchase of its shares; and the LR adds debt to make distributions (i.e., pay dividends) to existing shareholders. As a result, the target's debt is increased, usually significantly, resulting in greater leverage; potential cash flow and solvency issues; and, ultimately, a much larger risk of default, insolvency and liquidation. And, despite a few contrary feints by supporters of these deals (asserting supposed synergies with related entities, better management, and other intangible benefits), there is little or no quantifiable benefit to existing or future creditors;

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and the LBO or LR, essentially, transfers value to shareholders and increases the risk of nonpayment to creditors. As the Third Circuit noted in 1991:

> [t]he effect of an LBO is that a corporation's shareholders are replaced by secured creditors. Put simply, stockholders' equity is supplemented by debt. The level of risk facing the newly structured corporation rises significantly due to the increased debt to equity. The added risk is borne primarily by the unsecured creditors, those who will most likely not be paid in the event of insolvency. . . . The target . . . receives no direct benefit to offset the greater risk of now operating as a highly leveraged corporation.

Mellon Bank, N.A. v. Metro Communications, Inc., 945 F2d 635, 645-46 (3d Cir. 1991), cert. denied, 503 U.S. 937 (1992).

If there is a bankruptcy, the validity of such transactions will be tested by federal and state statutes governing fraudulent and avoidable transactions, most importantly sections 544 (which incorporates state fraudulent transfer laws) and 548 of the Bankruptcy Code. These statutes have two objectives: before the transaction, they provide guidance as to what transactions might be avoidable and the potential liabilities of involved parties (arguably, discouraging questionable transactions); and, after a transaction that leads to insolvency and/or bankruptcy, they provide for recoveries by injured creditors and the debtor-in-possession/trustee in bankruptcy. Obviously, as the dialogue above suggests, both effects depend substantially on the likelihood of real world consequences for parties to the transactions.

In the past decade or so, the deterrent effect has significantly weakened as a result of various statutes and court decisions that have provided new defenses and interpreted laws governing fraudulent and avoidable transfers narrowly and defenses broadly. This weakening of remedies, together with what appeared to be some judicial hostility to such litigation (resulting, in part, from the proliferation of quick section 363 sales in lieu of a plan process, the perception that out-of-the-money creditors used litigation to gain leverage and a "tip," the dramatic increase in the cost of litigation resulting from widespread e-discovery and stiffened pleading rules, and the increased involvement of unsympathetic hedge funds and claims traders on all sides) has led to a proliferation of transactions which are close to the line. The end result of these trends may be best illustrated by the report of the *Caesars* Examiner which describes the use of a multitude of techniques in an effort to protect what he found to be numerous probable or likely fraudulent transfers. (See *In re Caesars Entertainment Operating Company, Inc., et al.*, United States Bankruptcy Court for the Northern District of Illinois, Eastern Division, Chapter 11 Case No. 15-01145 (ABG), Docket No. 3720.)

The discussion will proceed in two parts. The first examines various statutes and decisions that undermined effective remedies. The second examines several recent decisions that may signal a turn in the road.

The Demise of Remedies

Defining Away Constructive Fraudulent Transfers

A constructive fraudulent transfer requires that the debtor receive "less than a reasonably equivalent value" for the transfer of an asset or the incurrence of an obligation, and (1) be insolvent at the time of, or be rendered insolvent by, the transfer or the incurrence of the obligation, (2) be engaged or about to engage in a business or transaction for which the remaining property constitutes "unreasonably small capital," or (3) intend or believe that it would incur debts which would be beyond its ability to pay as such debts matured. In most LBO/LR litigation, it is clear there was no reasonably equivalent value, so the case comes down to whether the transaction resulted in insolvency, unreasonably small capital or an inability to pay maturing debts. But, "solvency" is often hard to establish because it is measured as of the time of the transaction and is determined on a going concern basis. "Inability to pay" maturing debts can be even more problematic (although few cases find an inability to pay maturing debt without also finding unreasonably small capital) because those structuring the transaction can significantly increase the time before there is an "inability to pay" by permitting payment-in-kind or PIK interest (which, while limiting cash outflows, increases the debt) and/or by deferring principal payments on LBO and LR debt for two, or even four, years. So, the cases frequently turn to the "unreasonably small capital" test because it does seem to focus on the future and the likelihood of future financial problems.

On that issue, defendants received a strong dose of protection in *Moody v. Security Pacific Business Credit, Inc.*, 971 F.2d 1056 (3d Cir. 1992). *Moody* involved a leveraged buyout of Jeannette Corporation on July 31, 1981, for a sale price of $12.1 million, financed by a revolving line of credit of $11.7 million. After the buyout, Jeannette initially tracked expectations, but things soon went downhill; and, on October 4, 1982, an involuntary petition was filed, with the trustee later bringing a fraudulent conveyance lawsuit. The lower courts ruled for the defendants, and the Court of Appeals affirmed. Most significantly, the court suggested that an unreasonably small capital determination required that it be "reasonably foreseeable that the acquisition would fail" based on "reasonable" projections (giving effect to any existing line of credit). Moreover, although the court recognized that "projections tend to be optimistic" and that these were not "entirely on the mark," they were not unreasonable; the demise resulted from intense competition, a continued recession and mismanagement.

Although the *Moody* holding was somewhat dissipated over time, it was reinforced in early 2016 by two court of appeals decisions (although both were summary orders, with no precedential value). In the first, *In re Adelphia Communications Corp.*, 653 Fed. Appx. 19 (2d Cir. 2016), the debtor purchased its own stock and the trustee sought recovery from the sellers of the repurchased stock. The trustee cited evidence of financial issues, negative cash flow, ongoing fraud within the company,

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and default on existing bonds, but the court held the debtor could have sold assets or obtained sufficient credit for the foreseeable future, and cited expert testimony that similarly situated companies in the cable industry had been able to access the capital markets after disclosing a fraud.

In the second, *In re Semcrude L.P.*, 648 Fed. Appx. 205 (3d Cir. 2016), the trustee sought to recover two equity distributions in the bankruptcy that followed the first distribution by less than a year and the second by only five months. But, despite *Semcrude's* having violated the terms of its credit agreement and the banks having ultimately declared a default, the court of appeals concluded that *Semcrude* would have been adequately capitalized if it could have drawn on its credit facilities, and that the trustee's argument that it was reasonably foreseeable that *Semcrude* would not have had access to the line of credit because of improper trading activities rested on conjecture (citing a case for the proposition that "unreasonably small" is "fuzzy, and in danger of being interpreted under the influence of hindsight bias"). Ultimately, it "came down to a battle of experts"; and, obviously, defendants had the advantage of having prepared their story at the time the transactions took place.

There are significant themes in these opinions, but all are doubtful in the real world. First, the existence of a line of credit does not assure the availability of funds. Lenders have significant power to declare defaults, refuse advances, insist on loan modifications, or take other steps that negatively affect the business. Second, the denigration of "hindsight bias" seems an attempt to overcome the common sense view that, if bankruptcy follows shortly after the leveraged transaction (or reflects a consistent decline), capital probably was inadequate. Third, supposed "uncertainty" over "unreasonably small capital" simply avoids analysis. And, finally, insisting on "reasonable foreseeability" and the near certainty of bankruptcy—while ignoring financial devices (such as, PIK interest, long maturities, and principal deferrals) that postpone the inevitable—approaches a requirement that the debtor be clairvoyant.

It is striking that the cases above did not discuss the impact of the much higher level of credit risk on the business, and the changes in operations that were required to deal with the increased debt (especially true in *Moody*) and new management. They also ignored the fact that, in many questionable transactions, the dealmakers began to frame the issues, employ experts (who often act more like transactional advocates than dispassionate observers), and prepare their best case, at the time of the transaction. The key fact of leveraged transactions (as recently illustrated in cases following leveraged transactions in the oil and gas and retail industries) is not that they *will* lead to bankruptcy, but that the margin for error (and the ability to deal with almost any unanticipated circumstance or new situation) is significantly reduced, without any benefit to creditors or the business.

The Section 546(e) and Other Defenses

Section 546(e) provides a safe harbor for margin or settlement payments made by or to (or for the benefit of) a financial institution or certain other named parties, or a transfer by or to (or for the benefit of) a financial institution in connection with a securities contract. Its predecessor was first enacted in 1978 and amended several times; and the legislative history indicates that Congress was especially concerned with the possibility of a broad market meltdown and the cascading effect on market participants. There is no indication that Congress intended section 546(e) to have a broad effect on bankruptcy avoiding powers or to provide a vehicle for parties to "structure" their way out of liability under avoiding power statutes.

But gradually, bankruptcy lawyers began to realize section 546(e)'s potential as a defense to avoiding powers; and they have used it increasingly. Five courts of appeals decisions have held that section 546(e) applies to a transfer that involves a financial institution or one of the other financial parties mentioned in the statute, even though such party had not received or been the beneficiary of the transfer subject to avoidance; in other words, it applies to any transfer involving financial intermediaries (even if they had no beneficial interest in the transaction), thereby protecting the party actually receiving the transfer (even though that party was not named as a protected party in section 546(e)). In the real world, since the typical LBO or LR almost always involves wire transfers, this interpretation protected virtually all recipients of funds in LBO or LR transactions.

To be sure, there were some ways out. Section 546(e) was not applicable to transfers with the actual intent to defraud, but this standard was difficult to meet in a commercial transaction. Another possibility was to rely on state law avoidance powers to bypass the section 546(e) issue by having creditors transfer their avoidance claims to a litigation trustee for prosecution, and having the trustee argue that section 546(e) was not applicable because the trustee was proceeding under state law, and not under section 544(b) (which would trigger 546(e)). The initial cases were split, but in *In re Tribune Company Fraudulent Conveyance Litigation*, 818 F.3d 98 (2d Cir. 2016), the Second Circuit held that the failure to apply section 546(e) to the trustee's action would undermine the statute.

But, there were other defenses as well: Section 548's two year statute of limitations; and, if the debtor were a limited partnership or LLC, state LP or LLC laws with provisions that limit the ability to avoid distributions to equity holders to three years (arguably, preempting the longer state statutes of limitations that a trustee could invoke under section 544(b)—which were usually four, and sometimes six or more, years). See *In re Century City Doctors Hospital, LLC*, 466 B.R. 1 (Bk. C.D. Cal. 2012) (applying section 17-607(a) of the Delaware URULPA); Del. LLC Act § 18-607(c); NY LLC Law § 508(c). And, if the trustee were asserting a state law fraudulent conveyance under section 544(b), the defense of ratification (or similar doctrines) to preclude recoveries by debtholders who participated in the offending transactions and their assigns. See *In re Lyondell Chemical Co.*, 503 B.R. 348, 383-85 & nn. 174-76 (Bk. S.D.N.Y. 2014) (citing authorities).

The result of these statutes and decisions was that LBO and LR transactions were

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largely free from the threat of avoidance as fraudulent transfers under both section 548 and state law.

The Wheel Turns

Beginning in June of 2016, something changed: three decisions seemed to resuscitate the possible application of fraudulent transfer law to LBO transactions.

The first, and probably most significant, is *FTI Consulting, Inc. v. Merit Management Group, LP*, 830 F.3d 690 (7th Cir. 2016), involving the section 546(e) defense discussed earlier. Here, the Court acknowledged that section 546(e)'s language was ambiguous, and held that the defense can only be used by a protected party named in the statute that received or was the beneficiary of the subject transfer, and not simply because a financial institution or other protected party was an intermediary or conduit. Looking broadly at the relevant statutes, including the protections that Congress expressly provided to transferees (such as, the limited protections of section 548(d)(2) and the limited protection for recipients of charitable contributions) and the legislative history, the Court reasoned that section 546(e) was intended to protect only parties named in the statute who were actual recipients or beneficiaries of the transfer (thereby preventing a large bankruptcy from causing systemic risk to financial markets), not to extend its protection to non-named recipients or beneficiaries of the transfer merely because of the involvement of a named financial party as an intermediary or conduit bearing no risk from the transfer's avoidance. The court recognized that five circuits were *contra*, but noted that the Eleventh Circuit had earlier agreed with its conclusion. Given this circuit split, a Supreme Court review is a real possibility.

The second is the decision by the bankruptcy court in Delaware in *In re Physiotherapy Holdings, Inc.*, 2016 WL 3611831 (Bk. D. Del. 2016). The *Physiotherapy* court disagreed with the *Tribune* decision on the preemption of state fraudulent conveyance law in a case brought by a trustee asserting the assigned rights of creditors and dealing with accounting fraud discovered by the new owner's accountants four years after the transaction in question. The court suggested that, at least where there was no threat of a ripple or destabilizing effect on the relevant securities or financial markets and the transferees received payment for nonpublic securities, section 546(e) simply limited the trustee's ability to bring a fraudulent conveyance action, not a creditor's. The *Physiotherapy* court also held that the defense of ratification (discussed earlier) was not applicable to noteholders who purchased in reliance on the fraudulent financial statements.

In the third, *In re Lyondell Chemical Co.*, 554 B.R. 635 (S.D.N.Y. 2016), Judge Cote reversed a bankruptcy court's decision granting a motion to dismiss a complaint asserting an "actual intent" fraudulent conveyance in an LBO case. There, it was alleged that the CEO intentionally misstated projections and that the Board went along. The Court held that the knowledge of fraudulent projections could be imputed to the debtor pursuant to Delaware law and ordinary agency principles, since they were made within the scope of authority and duties of the CEO; and that plaintiff could plead either actual intent or a belief that harm was substantially certain to occur. Here, plaintiff adequately pled that the CEO and the management team had a motive to commit fraud to secure benefits, and three badges of fraud—a transfer of substantially all assets, transfers to insiders in the form of payments, and the debtor's having become insolvent soon after the transactions. To be sure, Judge Cote's decision was helped by the fact that the CEO had predicted bankruptcy in the event of an LBO. It has generally been considered difficult to successfully assert an actual intent fraudulent conveyance; and, while *Lyondell* certainly requires some fraud or dishonesty in the course of the transaction, there may be many situations where this is not difficult to find. The *Physiotherapy* case, discussed above, is to the same effect. See also *In re Sentinel Management Group, Inc.*, 728 F.3d 660 (7th Cir. 2013) (sustaining factual findings of an actual intent fraudulent transfer when the debtor transferred customer assets out of segregated accounts, and "knowingly exposed its FCM claimants to a substantial risk of loss of which they were unaware").

Important postscripts to these cases come in two areas involving, not constructive fraudulent transfers, but fraudulent transfers made with "actual intent to hinder, delay or defraud." First, from the Supreme Court's recent decision in *Husky Int'l. Elecs., Inc. v. Ritz*, 136 Sup. Ct. 1581 (2016), holding that claims arising out of "actual intent" fraudulent transfers constitute "actual fraud" and are not dischargeable in a personal bankruptcy; and, second, in the area of discovery, where the Supreme Court's definition of "actual fraud" in *Husky* can be used to bolster the argument that the crime-fraud exception to the attorney-client privilege applies in cases involving actual intent fraudulent transfers.

In *Husky*, an unpaid creditor asserted that its obligor had carried out numerous fraudulent transfers to strip itself of assets, and that Ritz (the controlling stockholder) was personally liable pursuant to a Texas statute permitting veil piercing in cases of "actual fraud" for the "direct personal benefit of the beneficial owner." The Supreme Court, relying heavily on historical precedent going back to the Statute of 13 Elizabeth in 1571, held that "the common-law term 'actual fraud' is broad enough to incorporate a fraudulent conveyance" and "anything that counts as 'fraud' and is done with actual intent is 'actual fraud.'" Consequently, section 523(a)(2)(A)'s exception to discharge for debts obtained by "actual fraud" could be applied to a shareholder's liability under state law for "concealment and hindrance" giving rise to a "fraudulent conveyance of property made to evade payment to creditors." A strong argument can be made that *Husky* and the "badges of fraud" concept should now be read into "actual intent" under section 548(a)(1)(A).

The discovery issue is dealt with in *Fragin v. First Funds Holdings LLC, et al.*, Index No. 652673/2014 (Sup. Ct. NY Co. 8/11/16), 2016 NY Slip Op 31537(U), a case also involving an actual intent fraudulent transfer. The plaintiff in *Fragin* alleged that defendants had transferred assets to a related entity to strip one of the defendants of assets, and brought the lawsuit against the

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transferees as well as their investment advisor and legal counsel (claiming that they had aided the transfers). Plaintiff sought discovery against legal counsel and, in response to counsel's claim of privilege, asserted the crime-fraud exception. The court held that the crime-fraud exception encompassed a fraudulent scheme or other wrongful conduct, and that there was probable cause to believe the defendants had committed an actual intent fraudulent conveyance based on the presence of various badges of fraud (including, the transfers having been made in the midst of litigation alleging significant debt owed by the transferor to its creditors; the close relationship of the transferor and the transferee, with insiders being left in control; and the transferor's having receiving no cash for the transfer of substantially all of its assets). The court, therefore, held that the communications with legal counsel sought in discovery were in furtherance of the alleged fraud and the crime-fraud exception applied. It is likely that the *Lyondell* plaintiffs will seek similar discovery. The second priority note holders in *Caesars* have already done so (See *Caesars,* Docket No. 4803).

Conclusion

Recent decisions suggest that the pendulum may be swinging toward a greater acceptance of the role that fraudulent transfer litigation can play after an LBO or LR fails; which may also provide clearer ground rules for structuring transactions in the future. The previously prevailing state of affairs may have been good for those who structured the LBOs and LRs, with the risk being borne by others; but it had little redeeming social value.

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