

# Solvency Compendium

A Summary of Relevant Court Cases Relating to  
Solvency Opinions and Issues



2026



## 2026 Solvency Compendium

### *A Summary of Relevant Court Cases Relating to Solvency Opinions and Fraudulent Transfer Analysis*

At Houlihan Capital, solvency opinions are a core focus and area of deep expertise. We have completed solvency opinions across a wide range of transactions, including leveraged buyouts, dividend recapitalizations, intercompany transfers, and complex restructurings. We are constantly researching case law on insolvency standards, fraudulent transfer analysis, and valuation methodology because we understand that legal precedent drives both the need for solvency opinions and the analytical frameworks that make them defensible.

This compendium reflects that commitment. It provides transactional attorneys with current legal precedents that shape solvency opinion requirements and fraudulent transfer standards, covering the evolving landscape of insolvency tests, valuation methodologies, and the circumstances under which transfers may be challenged or protected.

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### **Purpose of This Resource**

This compendium serves as a practical resource for transactional attorneys navigating solvency considerations in leveraged buyouts, restructurings, dividend recapitalizations, and other corporate transactions. Unlike broad financial or legal references, it focuses specifically on the intersection of legal process and financial analysis, providing current precedents that shape solvency opinion requirements and fraudulent transfer standards.

The cases address the three principal tests courts apply to determine insolvency — the balance sheet test, the cash flow test, and the inadequate capital test — as well as the circumstances under which actual and constructive fraudulent transfer claims arise. This specialized focus supports attorneys in their fiduciary duty considerations, litigation preparedness, and deal execution strategies.

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### **How to Use This Resource**

*For Client Discussions:* Reference relevant precedents to explain when solvency opinions may be required or advisable, particularly in leveraged transactions, intercompany transfers, or situations where a debtor's financial condition is uncertain. The case law helps illustrate the analytical frameworks courts rely on and highlights where financial analysis has proven decisive in litigation outcomes.

*For Precedent Research:* Locate relevant federal and state court rulings on insolvency standards, fraudulent transfer claims, and valuation methodology. The chronological organization allows you to track how standards have evolved and identify the most current judicial thinking on issues such as going concern valuation, the treatment of contingent liabilities, and the adequacy of capital following a transaction.

*For Transaction Structuring:* Use cases to anticipate potential solvency challenges and design more defensible transaction structures. Understanding what courts have scrutinized — such as the skewed projections in *Hexion v. Huntsman*, the suppressed valuations in *In re DSI Renal Holdings*, or the absent solvency opinion in *Wieboldt Stores* — helps avoid similar vulnerabilities.



*For Risk Assessment:* Identify the conditions under which solvency analyses have been successfully challenged, from unreliable expert methodologies to inadequate capitalization following highly leveraged transactions.

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### **When to Engage Independent Financial Advisors**

Consider involving firms like Houlihan Capital when a transaction involves significant leverage, intercompany transfers, equity distributions, or any circumstance where a debtor's post-transaction financial condition may be questioned. Solvency opinions provide an independent, rigorous assessment of a company's financial condition under the balance sheet, cash flow, and adequate capital tests — analysis that courts have consistently recognized as central to evaluating whether transfers are defensible.

As the cases in this compendium demonstrate, the presence of a credible, independent solvency opinion — grounded in sound methodology and developed without conflicts — meaningfully strengthens a transaction's defensibility. Its absence, conversely, has exposed parties to significant litigation risk. We provide independent financial analysis that reinforces transaction integrity and helps satisfy fiduciary requirements, particularly when transactions face potential legal scrutiny.

Our work frequently involves situations where the intersection of legal process and financial analysis matters most — exactly the scenarios these cases address.

For questions regarding solvency opinions or to discuss specific transaction scenarios, contact Houlihan Capital at [info@houlihancapital.com](mailto:info@houlihancapital.com).

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### **About Houlihan Capital**

Houlihan Capital is an employee-owned investment banking and valuation services firm that provides independent financial analysis and advisory services to support complex transactions and fiduciary processes. The firm specializes in fairness and solvency opinions, M&A advisory, strategic modeling, and portfolio valuation services.

With deep experience in leveraged transactions, restructurings, and insolvency-related analysis, Houlihan Capital delivers defensible solvency opinions trusted by boards of directors, legal counsel, lenders, and institutional investors. The firm's clients include public and private companies, private equity and venture capital funds, and legal teams navigating complex corporate transactions.

Houlihan Capital combines rigorous methodology with responsive, senior-level attention to help clients meet fiduciary obligations and regulatory requirements across diverse industries and transaction structures.

For more information, visit [houlihancapital.com](http://houlihancapital.com).

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### **Additional Resources**

For more information on solvency opinions and related topics, visit our resource library at [houlihancapital.com](http://houlihancapital.com). Additional publications and insights are available [here](#).

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The material contained in this publication is meant to provide general information regarding valuation topics. This publication does not constitute investment advice with respect to the securities of any company discussed herein, is not intended to provide information upon which to base an investment decision and should not be construed as such. Professional advice should be obtained before taking any action based on the information contained herein.

Publicly available information utilized in this publication has been obtained from sources deemed to be reliable. Houlihan does not guarantee the accuracy or completeness of the information provided within this publication. The material presented reflects information known to the authors at the time this publication was written, and this information is subject to change.



## Glossary:

**Actual Fraudulent Conveyance:** Actual intent to hinder, delay or defraud any creditor.<sup>1</sup>

*Cleveland-Cliffs Burns Harbor LLC v. Boomerang Tube, LLC*  
*Drivetrain, LLC v. X.Commerce, Inc.*  
*In re Tribune Company Fraudulent Conveyance Litigation*  
*In re Tribune Co. Fraudulent Conveyance Litig*  
*In re Adelphia Communications Corp.*  
*In re Lyondell Chem. Co*  
*In re Dressel Associates, Inc*  
*In re Vivaro Corp.*  
*In Re: Tribune Company, et. al*  
*In Re: Structurlite Plastics Corporation*  
*Crowthers McCall Pattern, Inc. v. Lewis*  
*In Re: The O'Day Corporation*  
*Wieboldt Stores Inc. v. Schottenstein, et al.*  
*United States of America v. Tabor Realty Corp.*

**Badges of Fraud:** Factors used to guide courts in determining whether debtor transferred property with specific intent to hinder, delay, or defraud creditors.<sup>2</sup>

*Cleveland-Cliffs Burns Harbor LLC v. Boomerang Tube, LLC*  
*In re Tribune Co. Fraudulent Conveyance Litig.*  
*In re Lyondell Chem. Co.*  
*In re Vivaro Corp.*

**Balance Sheet Test:** Requires the court to determine what value to attribute to the prospective and contingent liabilities of a company. The court must compare present assets with present and future liabilities and, making allowance for contingencies and deferred payments, assess whether the company can be reasonably expected to meet all of its liabilities.<sup>3</sup>

*Cleveland-Cliffs Burns Harbor LLC v. Boomerang Tube, LLC*  
*In re NCW Properties, LLC*  
*Drivetrain, LLC v. X.Commerce, Inc.*  
*In re Opus East LLC*  
*In re Vivaro Corp.*  
*In Re Premier Entertainment Biloxi LLC*  
*In Re: Heilig-Meyers*

**Cash Flow Test:** Whether the corporation has been paying bills on a timely basis and/or whether its liabilities exceed its assets.<sup>4</sup>

*In re NCW Properties, LLC*  
*In re Opus East LLC*

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<sup>1</sup> 12 Pa.C.S.A. § 5104

<sup>2</sup> 740 ILCS 160/5

<sup>3</sup> <https://www.lexology.com/library/detail.aspx?g=86db1422-4c16-47c1-b47e-fd31ec35d67f>

<sup>4</sup> *Pereira v. Farace*, 413 F.3d 330, 343 (2d Cir. 2005).



**Constructive Fraudulent Conveyance:** If a transfer was not made for fair consideration, then, depending upon financial condition of transferor at or immediately after time of transfer, the transfer may be fraudulent.<sup>5</sup>

*Cleveland-Cliffs Burns Harbor LLC v. Boomerang Tube, LLC*  
*In re NCW Properties, LLC*  
*Drivetrain, LLC v. X.Commerce, Inc.*  
*Development Specialists, Inc. v. Kaplan*  
*In re Adelpia Communications Corp.*  
*In re Princeton Paper Products, Inc.*  
*In re Dressel Associates, Inc.*

**Going Concern Value:** The value of a company as an ongoing entity. This value differs from the value of a liquidated company's assets, because an ongoing operation has the ability to continue to earn a profit, while a liquidated company does not.<sup>6</sup>

*In re Opus East LLC*  
*Payless Cashways, Inc. v. Hitachi Power Tools*  
*In the Matter of Taxman Clothing Co., Inc*

**Leveraged Buyout:** Acquisition of another company using a significant amount of borrowed money to meet the cost of acquisition.<sup>7</sup>

*In re Tribune Company Fraudulent Conveyance Litigation (April 2019)*  
*Development Specialists, Inc. v. Kaplan*  
*In re Tribune Co. Fraudulent Conveyance Litig.*  
*In re Lyondell Chem. Co.,*  
*In Re: Tribune Company, et. al*

**Trustee:** Person that holds and administers property or assets for the benefit of a third party.<sup>8</sup>

*In re NCW Properties, LLC*  
*In re Tribune Company Fraudulent Conveyance Litigation*  
*Development Specialists, Inc. v. Kaplan*  
*In re Opus East LLC*  
*In re Tribune Co. Fraudulent Conveyance Litig.*  
*In re DSI Renal Holdings, LLC*  
*In re SemCrude L.P.*  
*In re Lyondell Chem. Co.*  
*In re Princeton Paper Products, Inc.*  
*In re Dressel Associates, Inc.*  
*In Re Premier Entertainment Biloxi LLC*  
*Payless Cashways, Inc. v. Hitachi Power Tools*  
*In Re: Bay Plastics, Inc.*  
*In Re: The O'Day Corporation*  
*In the Matter of Taxman Clothing Co.*  
*Wieboldt Stores Inc. v. Schottenstein, et al.*

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<sup>5</sup> 12 Pa.C.S.A. § 5104

<sup>6</sup> [http://www.investopedia.com/terms/g/going\\_concern\\_value.asp?ad=dirN&qo=investopediaSiteSearch&qsrc=0&o=40186](http://www.investopedia.com/terms/g/going_concern_value.asp?ad=dirN&qo=investopediaSiteSearch&qsrc=0&o=40186)

<sup>7</sup> <http://www.investopedia.com/terms/l/leveragedbuyout.asp?ad=dirN&qo=serpSearchTopBox&qsrc=1&o=40186>

<sup>8</sup> <http://www.investopedia.com/terms/t/trustee.asp?ad=dirN&qo=serpSearchTopBox&qsrc=1&o=40186>



**Unreasonably Small Capital:** An "unreasonably small capital" would refer to the inability to generate sufficient profits to sustain operations. Because an inability to generate enough cash flow to sustain operations must precede an inability to pay obligations as they become due, unreasonably small capital would seem to encompass financial difficulties short of equitable solvency.<sup>9</sup>

*Cleveland-Cliffs Burns Harbor LLC v. Boomerang Tube, LLC*

*In re NCW Properties, LLC*

*Cleveland-Cliffs Burns Harbor LLC v. Boomerang Tube, LLC*

*Development Specialists, Inc. v. Kaplan*

*In re Opus East LLC*

*In re SemCrude L.P.*

*In re Vivaro Corp*

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<sup>9</sup> *Moody v. Security Pacific Business Credit, Inc.*, 971 F.2d 1056 (3d Cir. 1992).



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Cleveland-Cliffs Burns Harbor LLC v. Boomerang Tube, LLC No. 2022-0378-LWW, Del. Ch. Sept. 5, 2023

**DELAWARE CHANCERY COURT DENIED MOTION TO DISMISS IN PART WHERE TRADE CREDITOR SUFFICIENTLY ALLEGED THAT AN INSIDER-AFFILIATE FORECLOSURE SALE TRANSFERRED ASSETS FOR LESS THAN REASONABLY EQUIVALENT VALUE AND LEFT THE DEBTOR INSOLVENT**

*The trade creditor alleged that the debtor’s controlling owner orchestrated a foreclosure sale through an affiliate that stripped the debtor of substantially all assets while leaving unsecured creditors unpaid. The Court held that the allegations were sufficient at the pleading stage to support fraudulent transfer and successor liability claims against the alleged transferee, while dismissing all claims against the debtor’s controlling owner.*

Cleveland-Cliffs Burns Harbor LLC and Cleveland-Cliffs Steel LLC (together, “Cleveland-Cliffs”), trade creditors of Boomerang Tube, LLC (“Boomerang”), commenced an action challenging a foreclosure sale of substantially all of Boomerang’s assets. Cleveland-Cliffs alleged that Boomerang’s secured lender and controlling owner, Black Diamond Capital Management, L.L.C. (“Black Diamond”), structured an Article 9 foreclosure sale so that an affiliated entity could acquire Boomerang’s assets through a credit bid and continue operating the same business under a newly formed entity, PTC Liberty Tubulars, LLC (“PTC Liberty”).

According to the complaint, the foreclosure sale was structured to transfer Boomerang’s assets to PTC Liberty without assumption of Boomerang’s unsecured liabilities, leaving Boomerang insolvent and unable to satisfy trade creditor claims. Cleveland-Cliffs alleged that the assets transferred were worth significantly more than the \$16.5 million purchase price and that the sale was undertaken with the intent to hinder, delay, or defraud unsecured creditors. Black Diamond and PTC Liberty moved to dismiss the complaint.

The Court of Chancery granted Black Diamond’s motion to dismiss in full and granted PTC Liberty’s motion to dismiss in part and denied it in part. The Court held that Cleveland-Cliffs had stated reasonably conceivable claims for fraudulent transfer and successor liability against PTC Liberty, while dismissing all other claims.

**Fraudulent Transfer**

Cleveland-Cliffs asserted claims for constructive and actual fraudulent transfer under the Delaware Uniform Fraudulent Transfer Act, alleging that the Article 9 foreclosure sale transferred Boomerang’s assets for less than reasonably equivalent value while Boomerang was insolvent or rendered insolvent by the transfer.

With respect to constructive fraudulent transfer, the Court held that Cleveland-Cliffs adequately alleged that the foreclosure sale constituted a qualifying transfer of assets and that Boomerang failed to receive reasonably equivalent value. Although foreclosure sales often result in depressed prices and the assets were encumbered by liens, the Court emphasized that whether the



sale process produced reasonably equivalent value was a fact-intensive inquiry that could not be resolved at the pleading stage. The Court further noted that insolvency was sufficiently alleged and, in any event, was not disputed by the defendants at this stage.

The Court also held that Cleveland-Cliffs adequately pleaded an actual fraudulent transfer claim. The complaint alleged multiple badges of fraud, including that the transfer was made to an insider affiliate, involved substantially all of Boomerang's assets, occurred shortly after Boomerang incurred significant trade debt, was conducted on an expedited timeline with limited notice, and resulted in a substantial disparity between the value of the assets transferred and the consideration received. Accepting these allegations as true, the Court held that Cleveland-Cliffs sufficiently pleaded actual intent to hinder, delay, or defraud creditors.

The Court dismissed the fraudulent transfer claim against Black Diamond as a purported transfer beneficiary, holding that allegations of ownership and control alone were insufficient to establish beneficiary liability under Delaware law.

### **Successor Liability**

The Court next addressed Cleveland-Cliffs' successor liability claim against PTC Liberty. Although Delaware applies a narrow de facto merger doctrine, the Court held that the complaint did not support a de facto merger theory because the foreclosure sale involved a cash purchase and an express disclaimer of liability assumption.

The Court nevertheless held that Cleveland-Cliffs adequately alleged a "mere continuation" theory of successor liability. The complaint alleged that Boomerang effectively ceased to exist following the foreclosure sale and that PTC Liberty immediately continued the same business, using the same facilities, equipment, employees, management, customers, and website, and remained under the ownership and control of Black Diamond and its affiliates. At the pleading stage, these allegations were sufficient to permit the successor liability claim against PTC Liberty to proceed.

### **Court's Ruling**

The Court of Chancery concluded that Cleveland-Cliffs had stated reasonably conceivable claims for constructive and actual fraudulent transfer and successor liability against PTC Liberty, but failed to state any viable claims against Black Diamond. Accordingly, the Court denied PTC Liberty's motion to dismiss as to the fraudulent transfer and successor liability claims, granted PTC Liberty's motion as to the remaining claims, and granted Black Diamond's motion to dismiss in its entirety.



In re NCW Properties, LLC Case No. 18-20215, Adv. No. 20-00246, Bankr. N.D. Ill. Mar. 24, 2023<sup>1</sup>

## **BANKRUPTCY COURT DENIED SUMMARY JUDGMENT WHERE MATERIAL FACTUAL DISPUTES EXISTED REGARDING THE DEBTOR’S SOLVENCY**

*The Chapter 11 liquidating trustee alleged that the debtor was insolvent at the time of a pre-petition transfer, while the defendant submitted expert testimony concluding that the debtor was solvent and adequately capitalized. The Court held that the debtor’s solvency presented a disputed factual issue that could not be resolved on summary judgment.*

The liquidating trustee of NCW Properties, LLC (the “Debtor”) commenced an adversary proceeding seeking to avoid a pre-petition transfer made in February 2016 in connection with the buyout of the defendant’s equity interests as a constructively fraudulent transfer under section 548 of the Bankruptcy Code and applicable Illinois fraudulent transfer law. The transfer occurred more than two years prior to the Debtor’s Chapter 11 filing. The defendant moved for summary judgment, arguing that the trustee could not establish that the transfer was property of the Debtor or that the Debtor was insolvent at the time of the transfer, and further argued that he was entitled to judgment based on a good-faith-for-value defense.

The trustee alleged that the Debtor was insolvent when the transfer was made and relied on financial evidence, his own affidavit, and deposition testimony of the Debtor’s manager to support claims of balance-sheet insolvency, inadequate capitalization, and inability to pay debts as they came due. The defendant disputed these allegations and submitted an expert report opining that the Debtor was solvent at the relevant time under each insolvency framework, based on asset valuations, projected cash flow, and assumed equity infusions.

The Bankruptcy Court denied the motion for summary judgment, holding that the defendant failed to demonstrate that the material facts relevant to insolvency were undisputed and that competing evidence created genuine issues of fact requiring resolution at trial.

The Court identified three tests applicable to determining insolvency in fraudulent transfer actions: the balance sheet test, the cash flow test, and the inadequate capital test. The Court did not resolve insolvency under any test but concluded that disputed factual issues precluded summary judgment under all three frameworks.

### **Balance Sheet Test**

With respect to balance-sheet insolvency, the trustee contended that the Debtor’s liabilities exceeded the fair value of its assets at the time of the transfer, relying on management testimony and financial information supporting lower asset valuations. The defendant, by contrast, relied on expert testimony valuing the Debtor’s assets more favorably, including the Debtor’s car wash operations, and concluded that the Debtor’s assets exceeded its liabilities.

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<sup>1</sup> <https://www.ilnb.uscourts.gov/sites/ilnb/files/opinions/Stukesv.Argoudelis20ap00246OrderDenyingDefsMSJ.pdf>



The Court held that the parties' dispute centered on competing valuation methodologies, assumptions, and credibility determinations, all of which present classic factual disputes that cannot be resolved at the summary judgment stage.

### **Cash Flow Test**

The trustee also alleged that the Debtor was unable to pay its debts as they came due. The defendant disputed this allegation and relied on expert testimony and financial projections indicating that the Debtor had sufficient liquidity and cash flow at the relevant time.

The Court concluded that whether the Debtor was able to meet its obligations depended on disputed facts, including the reliability of financial projections and assumptions regarding operating performance, precluding summary judgment.

### **Inadequate Capital Test**

The trustee further alleged that the Debtor was left with unreasonably small capital following the transfer. According to the trustee, the Debtor lacked sufficient capital to sustain operations and meet foreseeable obligations.

The defendant disputed this characterization, pointing to expert analysis concluding that the Debtor remained adequately capitalized and capable of continuing operations after the transfer. The Court held that determining whether the Debtor had sufficient capital required resolution of disputed projections, assumptions, and testimony, and therefore could not be decided as a matter of law.

### **Court's Ruling**

The Bankruptcy Court concluded that genuine disputes of material fact existed with respect to the Debtor's solvency, including under the balance sheet, cash flow, and unreasonably small capital tests. Because insolvency is a fact-intensive inquiry requiring evaluation of competing evidence and witness credibility, the Court held that summary judgment was inappropriate. Accordingly, the Court denied the defendant's motion for summary judgment.

Drivetrain, LLC v. X.Commerce, Inc. Adv. Proc. No. 22-50448, Bankr. D. Del. Feb. 7, 2023<sup>2</sup>

**BANKRUPTCY COURT HELD THAT TRUSTEE SUFFICIENTLY ALLEGED DEBTOR’S INSOLVENCY AND LACK OF ADEQUATE CAPITAL, AND DENIED MOTION TO DISMISS FRAUDULENT TRANSFER CLAIMS**

*The Trustee alleged that the debtor operated at a loss for substantially its entire existence and was dependent on continual investor funding to meet obligations. The Court held that these allegations were sufficient to plead insolvency under applicable fraudulent transfer standards.*

Drivetrain, LLC (the “Trustee”), acting as trustee of the Cyber Litigation Trust, commenced an adversary proceeding seeking to avoid certain pre-petition transfers as actual and constructive fraudulent conveyances under the Bankruptcy Code and Delaware fraudulent transfer law. The Trustee alleged that the debtor, formerly known as NS8 Inc., and later renamed Cyber Litigation, Inc. (the “Debtor”), was insolvent for nearly its entire existence and lacked sufficient capital to sustain operations. The defendant moved to dismiss, arguing that the Trustee failed to adequately plead insolvency or lack of reasonably equivalent value.

The Trustee alleged that from its inception in 2016 through the petition date, the Debtor incurred more than \$13 million in operating expenses while never generating more than \$200,000 in annual revenue, and less than \$500,000 in total revenue over its entire existence. According to the complaint, the Debtor never achieved positive cash flow and relied on continual infusions of investor funds to finance its operations. The Trustee further alleged that the Debtor’s business model was fundamentally fraudulent and unsustainable absent ongoing investor funding.

The Bankruptcy Court denied the motion to dismiss with respect to the fraudulent transfer claims, holding that the Trustee’s allegations were sufficient at the pleading stage to support claims for both actual and constructive fraudulent conveyance.

The Court discussed three analytical frameworks for insolvency: the balance sheet test, the cash flow test, and the inadequate capital test. The Court relied primarily on the balance sheet and inadequate capital tests in denying the motion to dismiss.

**Balance Sheet Test**

Under the balance sheet test, a debtor is insolvent if the sum of its liabilities exceeds the fair value of its assets. The Trustee alleged that the Debtor’s liabilities exceeded its assets throughout its existence, rendering it insolvent on a balance sheet basis.

The defendant argued that more than \$60 million in investor funds should be treated as assets, which it contended would render the Debtor solvent. The Court rejected this argument, reasoning that the complaint alleged those investor funds were obtained through fraudulent misrepresentations. As a result, the investors allegedly held tort claims against the Debtor, giving

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<sup>2</sup> [https://www.deb.uscourts.gov/sites/deb/files/opinions/20230207-drivertrain-v-xcommerce\\_0.pdf](https://www.deb.uscourts.gov/sites/deb/files/opinions/20230207-drivertrain-v-xcommerce_0.pdf)



rise to corresponding liabilities that must be considered in the insolvency analysis. The Court concluded that inclusion of the investor funds did not defeat the Trustee's insolvency allegations.

### **Inadequate Capital Test**

The Court next considered whether the Trustee adequately alleged insolvency under the unreasonably small (or inadequate) capital test, which examines whether a debtor was left with insufficient capital to continue operating.

The Trustee alleged that the Debtor lacked adequate capital nearly from inception. The complaint emphasized that the Debtor incurred substantial operating losses, never generated positive cash flow, and depended on continual investor funding to meet operating expenses and obligations. The Trustee alleged that the Debtor operated in a persistent state of insolvency and could not sustain operations without ongoing infusions of capital.

The Court held that these allegations were sufficient at the pleading stage to support a claim that the Debtor was left with unreasonably small capital.

### **Holding**

The Bankruptcy Court held that the Trustee sufficiently alleged insolvency under the balance sheet and unreasonably small capital tests and adequately pled lack of reasonably equivalent value for purposes of constructive fraudulent transfer claims. Accordingly, the Court denied the defendants' motion to dismiss the fraudulent conveyance claims, while granting the motion to dismiss the preference claim. The fraudulent transfer claims were permitted to proceed.



*In re Tribune Company Fraudulent Conveyance Litigation (April 2019)*<sup>3</sup>

**U.S. DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK RULED THAT PAYMENTS IN A LEVERAGED BUYOUT TO THOUSANDS OF SHAREHOLDERS ARE PROTECTED BY SAFE HARBOR BECAUSE HAVING A TRADITIONAL FINANCIAL INSTITUTION AS AN INTERMEDIARY IN THE TRANSACTION CAN QUALIFY THE COMPANY MAKING THE PAYMENTS AS A FINANCIAL INSTITUTION WITHIN THE MEANING ON BANKRUPTCY CODE SECTION 546(E).**

*Creditors of the Tribune Company filed a claim alleging fraudulent conveyance by the Tribune Company, taking the position that Merit Management Group LP v. FTI Consulting, Inc. invalidated the Court's prior ruling. The Court denied the motion to amend the claim because all shareholder defendants would be able to successfully assert a safe harbor defense in a motion to dismiss.*

The Tribune litigation arose out of the 2007 leveraged buyout of the Tribune Company and its subsequent bankruptcy in 2008. In 2010, the unsecured creditors committee on Tribune's bankruptcy estate ("Committee") filed a suit seeking to recover over \$8 billion of payments made to over 5,000 former shareholder defendants. The Committee, however, asserted only "intentional" fraudulent transfer claims because at that time, prior to Merit Management, it was clear under applicable law that the Section 546(e) safe harbor barred constructive fraudulent transfer claims for payments made through banks or trust companies. Following Merit Management's narrowing of the Section 546(e) safe harbor, the litigation trustee, as successor to the Committee, moved to amend the complaint to add constructive fraudulent transfer claims. Judge Cote denied the motion for two independent reasons: (i) amendment would be futile because Section 546(e) continues to bar constructive fraudulent transfer claims, and (ii) amending the complaint at this time, more than ten years after the transactions at issue, would be prejudicial to thousands of defendants. The same Section 546(e) argument has already been briefed in the Second Circuit Court of Appeals in a related litigation initiated under state law by Tribune's individual creditors.

### **Implications**

The Tribune decision provides a road map to secure bankruptcy safe harbor defenses for payments made in leveraged buyouts, certain leveraged recapitalizations, and other similar transactions. The Supreme Court's Merit Management decision disrupted a widely recognized interpretation of the Bankruptcy Code that protected many transactions from constructive fraudulent transfer risk if they were effected through financial institutions as intermediaries. Judge Cote's opinion reaffirms the Bankruptcy Code's previous protection from constructive fraudulent transfer claw back claims as long as the company making the payments is a "customer" of a traditional financial institution, and that financial institution acts as the company's agent in making the payments. Although not

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<sup>3</sup> In re Tribune Company Fraudulent Conveyance Litigation, No. 11md2296 (S.D.N.Y. Apr. 23, 2019)



specifically addressed, the reasoning of Judge Cote’s decision would similarly protect transfers where the recipient meets those same “financial institution” criteria (it is a “customer” of a traditional financial institution and that financial institution acts as the recipient’s agent).

The Tribune decision is the first significant decision to consider how the safe harbor applies in the wake of Merit Management. While Judge Cote’s reasoning is persuasive and the S.D.N.Y. District Court is influential, the ruling is not binding on other District Court judges.



*Development Specialists, Inc. v. Kaplan*, 1:16-CV-421-DBH, 2017 WL 1493669 (D. Me. Apr. 26, 2017)

**BANKRUPTCY COURT DID NOT ERR IN FINDING THAT SALE OF SHAREHOLDERS' EQUITY INTERESTS, AS PART OF MERGER, WAS NOT CONSTRUCTIVELY OR ACTUALLY FRAUDULENT.**

*In Development Specialists v. Kaplan, the Court determined that the sale of shareholder's equity interests in the corporation, as part of a merger, was not actually or constructively fraudulent. In its decision, the Court found that the Trustee did not establish the other two elements of fraud, including unreasonably small capital or inability to pay debts as they came due.*

In 2007, leather tanning and finishing company, Prime Maine, started to experience economic challenges. Meriturn Partners, LLC (“Meriturn”), a private equity firm, expressed an interest in merging Prime Maine with Irving Tanning. In November 2007, after negotiations, Prime Maine and Irving Tanning agreed to come under the common ownership of new holding company, Prime Delaware. Meriturn contributed \$3 million while Irving Tanning, Prime Delaware, Prime Maine, Prime Missouri, and Cudahy entered into lien-secured agreements to complete the financing. In the end, Irving Tanning, Prime Maine, and Cudahy all executed a \$1,860,000 term note, a \$40,000,000 revolving note, and a \$25,000,000 revolving note, payable to Wells Fargo. Irving Tanning, Prime Delaware, Prime Maine, Cudahy, and Prime Missouri directed Wells Fargo to pay \$10,629,459 in cash proceeds to Prime Maine’s shareholders, among other agreements, including a promissory note, and a cash value of life insurance policies to certain Prime Maine shareholders. As a result, Prime Maine shareholders received over \$23.6 million in exchange for their stock and agreements.

The Trustee claimed that the transaction amounted to a leveraged buyout (“LBO”) that Prime Maine shareholders are responsible for fraudulent transfers by Prime Delaware, Prime Maine, and Prime Missouri. After a bench trial, the bankruptcy court held that the Trustee had not met its burden on any of the claims. The Trustee appealed this order.

**Actual Fraudulent Transfers**

First, the Trustee alleged there was actual fraud in the transfers made by Prime Maine and Prime Missouri in the transaction. A transfer is fraudulent if the debtor “made the transfer or incurred the obligation...[w]ith actual intent to...defraud any creditor of the debtor.”<sup>4</sup>

The bankruptcy court found that the shareholder defendants were not involved in actual fraud. The Trustee noted that the Uniform Fraudulent Transfer Act focused on the debtors, not the shareholders. The Court opined that “individuals’ intent could be attributed to the corporations,”<sup>5</sup>

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<sup>4</sup> 14 M.R.S.A § 3575(1)(A).

<sup>5</sup> *Dev. Specialists, Inc. v. Kaplan*, 1:16-CV-421-DBH, 2017 WL 1493669, at \*3 (D. Me. Apr. 26, 2017).



but “[i]t would be a pointless exercise to send the case back to the bankruptcy court now to ask for findings about these two debtors as distinct from the shareholders on this issue.”<sup>6</sup>

### **Constructive Fraudulent Transfers**

Next, the Trustee alleged constructive fraud in the transaction made by Prime Delaware, Prime Maine, and Prime Missouri. A transfer is fraudulent if the debtor:

Made the transfer or incurred the obligation...[w]ithout receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor:

- (1) Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
- (2) Intended to incur, or believed or reasonably should have believed that he would incur, debts beyond his ability to pay as the debts became due.<sup>7</sup>

The bankruptcy court concluded that the Trustee did not satisfy the first element, noting that Prime Delaware did receive “reasonably equivalent value in exchange for the transaction with Prime Maine’s shareholders.”<sup>8</sup> This Court affirmed the bankruptcy court’s decision, noting that the Trustee was not able to establish either of the two elements of constructive fraud. Further, the Court noted that “there is no evidence... that would support a finding of unreasonably small capitalization or inability to pay debts as to either Prime Maine or Prime Missouri if in fact their corporate parent/grandparent Prime Delaware was not subject to either of those taints as the bankruptcy court found.”<sup>9</sup>

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<sup>6</sup> *Id.*

<sup>7</sup> *Id.* at 4.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.* at 7.



*In re Opus East LLC, 16-2202, 2017 WL 4310367 (3d Cir. Sept. 28, 2017)*

**BANKRUPTCY COURT DID NOT ERR IN FINDING THAT THE BANKRUPT LLC’S ASSETS EXCEEDED ITS DEBTS AND WAS NOT INSOLVENT AT THE TIME OF THE CHALLENGED TRANSFERS.**

*The Trustee alleged that Opus East was insolvent at the time of selective transfers. The Court ruled that Opus East’s projections were reasonable and Opus East believed it would have adequate cash and capital, notwithstanding the risks it faced.*

Appellant Jeffrey L. Burch (“Trustee”) for Opus East LLC (“Opus East”), appealed the district court’s decision affirming the bankruptcy court’s judgment. The Trustee challenged the bankruptcy court’s findings regarding Opus East’s insolvency and a breach of fiduciary duty claim against Opus East’s chairman.

Opus East was formed in September 1994 in order to develop and sell commercial real estate projects. It was part of a network of real estate companies, known as Opus Group, which was owned by two trusts (“Trusts”). Opus East was a subsidiary of Opus LLC. Appellee, Mark Rauenhorst (“Rauenhorst”) was chairman of Opus LLC and Opus East.

Opus East owned special entities (“SPEs”), which were formed for real estate projects Opus East developed. Opus East made compulsory annual distributions to Opus LLC, which then made distributions to the Trusts. Between 1994 and 2008, Opus East’s equity increased from \$12 million to \$75 million. After the market collapse of 2008, Opus East found it challenging to find buyers for its developments.

In 2004, Opus East formed Maryland Enterprises, LLC (“ME”), an SPE, in order to bid on a project for the United States General Services Administration (“GSA”). The GSA planned construction of an office for the National Oceanic and Atmospheric Administration (“NOAA Project”). ME was awarded the contract in March 2005. The project had numerous problems, including increased construction costs, as well as disagreements with the GSA. Due to these issues, ME stopped construction on the NOAA Project.

In March 2009, the GSA proposed a settlement, which ME rejected. In April 2009, Opus East defaulted on a bank loan financing the construction and abandoned the project. In May 2009, ME sued the GSA for breach of contract.

Anticipating bankruptcy, the Trusts invested \$100,000 into new created GAMD LLC (“GAMD”), which then acquired ME from Opus East in exchange for \$100,000 and an interest in the first \$400,000 from the proceeds of the GSA lawsuit.

In an effort to avoid bankruptcy, Opus East entered into a \$93 million real estate project (“100 M Street Project”), but was unable to close the deal. Opus East filed for Chapter 7 bankruptcy on July 1, 2009. The bankruptcy court held that Opus East became insolvent on February 1, 2009.



In March 2015, the bankruptcy court ruled in favor of Opus East. On appeal, the Trustee challenged “the Bankruptcy Court’s determination that Opus East was solvent through February 1, 2009; and its conclusion that Mark Rauenhorst did not breach his fiduciary duty with respect to the transfer of Opus East’s assets to GAMD.”<sup>10</sup>

The Court employed three tests to determine whether Opus East was insolvent at a given point in time: the balance sheet test, the cash flow test, and the inadequate capital test.

### **Balance Sheet Test**

“Under the balance sheet test, a debtor is insolvent if the sum of its liabilities is greater than the sum of its assets, at fair valuation.”<sup>11</sup> To determine fair valuation, the debtor’s assets were valued on a going concern or liquidation basis. Liquidation basis would only be appropriate where bankruptcy was imminent. Going concern value was determined “by looking at an asset’s ‘market value,’ analyzed in a ‘realistic framework’ that accounts for the ‘amounts [of cash] that can be realized in a reasonable time assuming a willing seller and a willing buyer.’”<sup>12</sup>

The Trustee claimed that Opus East was balance sheet insolvent by June 30, 2008. The Bankruptcy Court, however, found that Opus Group’s “higher valuation of the debtor’s assets to be more credible, noting that through 2008 Opus East was able to pay creditors without liquidating any assets.”<sup>13</sup> Further, the Bankruptcy Court held that Opus East was allowed to rely on anticipated profits from the 100 M Street Project.

The Trustee challenged Opus Group’s analysis and the bankruptcy court’s reliance on it for several reasons. First, the Trustee questioned the accuracy of pre-2009 reports, issued by Opus East’s third-party auditor. This Court rejected Trustee’s first contention, noting that the audit reports were “only part of its independent analysis of Opus East’s financial condition.”<sup>14</sup>

Next, the Trustee questioned Opus East’s ability to sell assets and obtain loans, alleging that the assets were only sold to related parties and the loans were secured and limited to specific real estate projects. The Court held that the assertions did not suggest that the transactions were unfair.

Finally, the Trustee argued that the bankruptcy court provided undue weight on the anticipated profits from the 100 M Street Project, given the market conditions. The Court noted that some Opus East executives were concerned about a possible failure surrounding the project, but “this does not undermine the bankruptcy court’s finding that nevertheless Opus East did not know that it must abandon the Project prior to February 2009.”<sup>15</sup>

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<sup>10</sup> *In re Opus E. LLC*, 16-2202, 2017 WL 4310367, at \*2 (3d Cir. Sept. 28, 2017).

<sup>11</sup> *In re R.M.L., Inc.*, 92 F.3d 139, 153 (3d Cir. 1996)

<sup>12</sup> *In re Trans World Airlines, Inc.*, 134 F.3d 188, 193-94 (3d Cir. 1998)

<sup>13</sup> 16-2202, 2017 WL 4310367, at \*3 (3d Cir. Sept. 28, 2017).

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* at 4.



### **Cash Flow Test**

“A debtor is cash flow insolvent if, at the time a transfer is made, the debtor intended to incur, or believed or reasonably should have believed that it would incur, debts beyond its ability to pay as they came due.”<sup>16</sup>

The Trustee contended that Opus East was cash flow insolvent as early as December 2006. According to the Trustee, Opus had taken on unrealistic spending commitments and “relied on its ability to obtain credit, including inside and third-party loans, to cover construction obligations.”<sup>17</sup> The Court rejected the Trustee’s argument, opining that there was no reason why Opus East was not allowed to rely on its access to insider credit when forecasting its ability to pay debts.

### **Inadequate Capital Test**

A debtor was insolvent if it “was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital.”<sup>18</sup> The Trustee asserted that Opus East was not sufficiently capitalized through 2009. In support, the Trustee noted that the debtor’s had a projected cash flow shortage in 2006, which delayed the start of certain projects, as well as a number of construction commitments in 2007 and 2008. The Court noted that while Opus East faced financial difficulties in 2007 and 2008, the Trustee failed to consider that Opus East continued to sell and develop projects, paid creditors, and continued to obtain loans.

### **Breach of Fiduciary Duties**

The Trustee claimed that Rauenhorst breached his fiduciary duty to Opus East when he transferred ME to GAMD before Opus East’s bankruptcy. The Court rejected the Trustee’s argument. The Court noted that Rauenhorst believed the transaction to be in Opus East’s best interest, and the Trustee did not present evidence that Rauenhorst demonstrated “...a conscious disregard for his duties.”<sup>19</sup>

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<sup>16</sup> *Id.* at 3.

<sup>17</sup> *Id.* at 4.

<sup>18</sup> 11 U.S.C. § 548(a)(1)(B)(ii)(II).

<sup>19</sup> *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 67 (Del. 2006).

*In re Tribune Co. Fraudulent Conveyance Litig.*, 11-MD-2296 (RJS), 2017 WL 82391 (S.D.N.Y. Jan. 6, 2017)

**SOLVENCY AND VIABILITY OPINIONS AFTER EACH STEP OF THE TRANSACTION STRENGTHENED TRIBUNE’S AND ITS SPECIAL COMMITTEE’S REASONING FOR ACCEPTING THE LEVERAGED BUYOUT.**

*After a leveraged buyout, the Trustee sought to claw money back, stemming from the leveraged buyout, which resulted in \$8 billion paid to Tribune’s shareholders in exchange for their shares. The Court rejected the Trustee’s claims of fraudulent conveyance, noting that there was no intent to hinder, delay, or defraud the creditors.*

Before filing for bankruptcy in 2008, Tribune was, “America’s largest media and entertainment company.”<sup>20</sup> In 2006, after Tribune fell into financial troubles, Chandler Trusts, which owned 20% of Tribune’s stocks, persuaded Tribune’s board of directors (the “Board”) to form a special committee where it would explore strategic transactions, including a leveraged buyout (“LBO”).

In February 2007, Equity Group Investments (“EGI”), along with investor Sam Zell, proposed that affiliate EGI-TRB, buy Tribune’s stock, dependent upon a merger. After negotiations, Zell and EGI proposed a two-step LBO. In step one, Tribune would “borrow approximately \$7 billion in debt and purchase approximately 50% of Tribune’s outstanding shares for \$34 per share in a tender offer”<sup>21</sup> (“Step One”). In step two, “Tribune would purchase Tribune’s remaining shares and borrow an additional \$3.7 billion in a go-private merger with the newly formed Tribune Employee Stock Ownership Plan (“ESOP”), and, as a result, Tribune would become wholly owned by the ESOP”<sup>22</sup> (“Step Two”).

The Board hired Duff & Phelps to provide a solvency opinion for the two-step LBO. Tribune requested that Duff & Phelps factor in an expected \$1 billion in future tax savings that result from turning the company into an S-corporation, but Duff & Phelps declined to factor this into the solvency opinion. In April 2007, Duff & Phelps delivered a viability opinion, which determined that “the fair market value of Tribune’s assets would exceed the value of its liabilities on a post-transaction basis.” The viability opinion “was the equivalent of a solvency opinion,”<sup>23</sup> but it accounted for Tribune’s future tax savings. On April 1, 2007, the Board and special committee approved the LBO.

Ten days after the Board approved the LBO, Tribune hired Valuation Research Company (“VRC”) to complete a series of solvency opinions, which were presented to the Board before the completion of each step of the LBO. VRC issued its solvency opinion for Step One on May 24, 2007, which concluded that Tribune would be solvent following the first step. The second opinion was

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<sup>20</sup> *In re Trib. Co. Fraudulent Conveyance Litig.*, 11-MD-2296 (RJS), 2017 WL 82391, at \*1 (S.D.N.Y. Jan. 6, 2017).

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> *Id.* at 2.



presented on December 18, 2007, where VRC forecasted Tribune’s growth. Relying on the solvency opinion, Tribune began repurchasing 119 million shares of common stock at \$34 per share.

After completion of the LBO, Tribune began to experience financial difficulties and did not meet its projected growth rate. Tribune filed for Chapter 11 bankruptcy on December 8, 2008.

Tribune’s litigation Trustee sought to “claw back money that was distributed to various entities and individuals (“Defendants”) as a result of the leveraged buyout, including over \$8 billion paid to Tribune’s shareholders (“Shareholder Defendants”) in exchange for their shares in Tribune.”<sup>24</sup> Shareholder Defendants moved to dismiss the Trustee’s fraudulent conveyance claim. The Court granted Shareholder Defendants’ motion to dismiss.

The Court analyzed Tribune’s intent based on each of Tribune’s agents who helped facilitate the LBO. The groups are discussed below.

### **Shareholders**

The Trustee conceded that the “intent of Tribune’s public shareholders is irrelevant.”<sup>25</sup> Therefore, the Court held that the Trustee failed to sufficiently allege that Tribune’s shareholders possessed “an actual intent to hinder, delay, or defraud Tribune’s creditors.”<sup>26</sup>

Defendants claimed that because the Trustee failed to allege actual fraudulent intent on behalf of the shareholders, the Trustee was precluded from finding that Tribune possessed the requisite intent to prove actual fraudulent conveyance. The Court rejected Defendants’ contention, noting that Defendants did not provide any cases to support their proposition, and “the Court need not address it, since the Court finds that the Trustee has also failed to allege that any other relevant actors had actual intent sufficient to support a claim under Section 548(a)(1)(A).”<sup>27</sup>

### **Board of Directors**

Next, the Trustee claimed Tribune’s Board acted with fraudulent intent. The Court noted that the Board passed its decision making on to the independent directors, which made up the special committee, which was formed for the purpose of assessing the LBO. Therefore, the Board was not involved in the LBO decision making and the Trustee must have plead facts that demonstrated the independent directors possessed “actual intent to hinder, harm, or delay Tribune’s creditors.”<sup>28</sup>

### **Officer Defendants**

The Trustee contended that the Defendants had the intent to hinder, delay, or defraud Tribune’s creditors, and urged that their fraudulent intent be “imputed to the corporation.”<sup>29</sup> The Court rejected Trustee’s argument.

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<sup>24</sup> *Id.* at 1.

<sup>25</sup> *Id.* at 6.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*



No test had been established in the Second Circuit, but the Court found the First Circuit test to be applicable in this situation. The Court agreed with the First Circuit, which determined that “the intent of the debtor’s officers may be imputed to the debtor if the officers were ‘in a position to control the disposition of [the transferor’s] property,’ thereby effectuating the underlying offense.”<sup>30</sup>

#### **a. Voting Power**

The Trustee alleged Tribune’s CEO was associated with Foundations, which owned 13% of Tribune’s outstanding stock. The Court rejected the Trustee’s argument, noting that the Trustee did not plead “sufficient allegations of control, since there is no basis for inferring that any of the officer defendants ‘possessed sufficient voting power to remove [the directors] from their positions if they rejected’ the LBO.”<sup>31</sup>

#### **b. Managerial Power**

The Trustee contended that Defendants controlled the shareholders because Tribune CEO and certain Defendants attended all but one special committee meeting. The Court denied the Trustee’s allegations, opining that the allegations, alone, did not support an inference of managerial control.

Next, the Trustee contended that VRC’s inclusion of an expected tax savings in the solvency opinion was inappropriate. The Court noted that the special committee hired its own financial advisor, Morgan Stanley, to assess Tribune’s solvency. In addition, the independent directors considered Duff & Phelps’s viability opinion, which concluded that Tribune’s assets exceeded its liabilities after the LBO. Any projections used in the calculations were reviewed by financial advisers and “were not merely rubber stamped by the independent directors.”<sup>32</sup>

Finally, the Trustee alleged that Defendants misled VRC when they “indicated in a December 2, 2007 telephone call and in a December 20, 2007 letter that Morgan Stanley had confirmed their refinancing assumption,”<sup>33</sup> and the misrepresentation induced VRC into providing a solvency opinion. The Court declined to follow the Trustee’s reasoning. In its opinion, the Court noted that the “officer defendants were plainly not ‘in a position to control’ the independent directors because of Valuation Research’s alleged failure to seek or confirm Morgan Stanley’s view of the transaction and the independent directors’ alleged failure to scrutinize the assumptions underlying the solvency opinion.”<sup>34</sup>

#### **Badges of Fraud**

The Court held that the badges of fraud, alleged by the Trustee, were “insufficient to raise a strong inference that the independent directors acted with an actual intent to hinder, delay, or defraud Tribune’s creditors.”<sup>35</sup>

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<sup>30</sup> *Id.*

<sup>31</sup> *Id.* at 7.

<sup>32</sup> *Id.* at 9.

<sup>33</sup> *Id.* at 10.

<sup>34</sup> *Id.*

<sup>35</sup> *Id.* at 13.



**a. Motive and Opportunity**

The trustee claimed the independent directors wanted to hinder, delay, or defraud Tribune’s creditors “based on the fact that, as shareholders, they would receive consideration in exchange for their shares only if the LBO were consummated.”<sup>36</sup> The Court rejected this argument, noting that this was not enough evidence to prove fraud. “[T]he mere fact that the independent directors received shareholder transfers in connection with the LBO fails to support a strong inference of scienter.”<sup>37</sup>

**b. Conscious Misbehavior or Recklessness**

Next, the Court considered whether the Trustee sufficiently alleged strong circumstantial evidence of conscious misbehavior or recklessness on behalf of the independent directors. If the motive to commit fraud is not apparent, the circumstantial allegations of conscious misbehavior or recklessness “must be correspondingly greater in order to withstand dismissal.”<sup>38</sup>

The Trustee alleged that the independent directors acted recklessly when approving the LBO, despite Tribune’s deteriorating financial performance. Additionally, Trustee contended that the independent directors were reckless when they accepted management’s aggressive financial projections, without considering the challenges facing the newspaper industry, as well as Tribune’s past financial performance. The Court concluded that the Trustee failed to raise a strong inference of recklessness or conscious misbehavior.

In its reasoning, the Court noted that the special committee did not act recklessly when accepting management projections. Morgan Stanley reviewed the management projections and took further steps to analyze whether Tribune would remain solvent, post LBO. Additionally, Duff & Phelps issued a viability opinion and VRC issued solvency opinions after Step One and Step Two of the LBO were completed.

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<sup>36</sup> *Id.* at 16.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*



*In re DSI Renal Holdings, LLC*, 11011722 WL 3105842 (Bankr. D. Del. July 20, 2017)

**THE TRUSTEE STATE A PLAUSIBLE CLAIM FOR ACTUAL FRAUDULENT TRANSFER.**

*The Trustee alleged that Defendants restructured DSI entities through a series of agreements, transfers, and transactions, that stripped DSI Renal Holdings of its assets. The Trustee claimed the transfers were fraudulent, and the Court held that the Trustee had properly alleged the transfers were fraudulent, and denied Defendant’s request to dismiss the count.*

In 2011, DSI Renal Holdings LLC (“DSI Renal”), DSI Hospitals, Inc. (“DSI Hospitals”), and DSI Facility Development, LLC (“DSI Facility” collectively, the “Debtors”), filed petitions for relief under Chapter 7 of the US Bankruptcy Code. In May 2013, the Chapter 7 estate of the Debtors (“Trustee”) filed an adversary complaint against Apollo Investment Corporation (“Apollo”), Ares Capital Corporation (“Ares”), the Centre Defendants, the Directors and Officer Defendants (“D & O”), and Northwestern Mutual Life Insurance Company (“NML Defendants” collectively, “Defendants”). The Complaint sought to recover around \$425 million from alleged fraudulent transfers. Defendants moved to dismiss. The Court denied in part and granted in part.

DSI Hospitals owned a treatment center in Pennsylvania (“Bucks County Hospital”). The Bucks County Hospital was not profitable and Defendant Lief Murphy, CEO for the Debtors, recommended closing Bucks County Hospital. The Trustee alleged that in order to avoid parent company’s, DSI Holding, liability for the Bucks County Hospital debt, the Debtors’ filed Chapter 7 bankruptcy in Tennessee Bankruptcy Court. Court documents showed Bucks County Hospital’s debt exceeded \$36 million to more than 200 creditors.

**Improved Business**

Defendant Murphy implemented a plan to increase revenue for the Debtors. Though revenue enhancement opportunities and expense reduction, the Debtors achieved two consecutive quarters of improved financial operations.

**Sale Process**

The Trustee alleged that, “as part of a ruse to appease its lenders and establish a suppressed ‘restructure valuation’ to the detriment of certain shareholders and ‘all of the Debtors’ non-insider creditors,”<sup>39</sup> the Debtors hired Goldman Sachs to solicit interest in the Debtors and their subsidiaries. During the solicitation process, Goldman Sachs used out of date earnings projections, which led to companies submitting lower offers.

**Fraudulent Transfer of DSI Renal**

In 2009, directors of DSI Holding and DSI Renal voted to terminate the Goldman Sachs sales process. The directors did not provide any further information to the bidders. Instead of selling,

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<sup>39</sup> *In re DSI Renal Holdings, LLC*, 11011722 WL 3105842, at \*5 (Bankr. D. Del. July 20, 2017).



Defendants pursued a restructuring plan. The Trustee claimed that the Centre Defendants developed the DSI restructuring plan, as they owned 46% of DSI Holding stock and controlled the majority of the Debtors' boards. In 2010, Defendants valued the 106 clinics and 26 acute care facilities ("Renal Business") at \$477.7 million. "To enable insiders to purchase the Renal Business, the Trustee alleges that the restructuring value was not based upon fair market value, but upon the debt associated with the continued operation of the Renal Business and restructuring costs."<sup>40</sup>

Trustee claimed Defendants restructured the DSI entities through complicated agreements and transactions that stripped DSI Renal of its assets by "diluting its 100% ownership of the operating subsidiaries to less than one-thousandth of a percent of an interest in the post-restructuring entity."<sup>41</sup> Further, the Trustee alleged the Debtors were left with liabilities of over \$40 million and assets as low as \$300,000. When DaVita, Inc. bought the Renal Business in 2011, Defendants gained more than \$425 million, while the Debtors remained insolvent. Defendants moved to dismiss the claims.

## Analysis

### 1. Actual Fraudulent Transfers

The Trustee alleged that "...parties involved intended to defraud outside creditors by using the Goldman Sachs sale process to set a low value to justify the transfer and sale of DSI Renal, which, in turn, favored inside creditors."<sup>42</sup> The Court denied Defendants motion to dismiss this count. The Court opined that the Trustee had adequately pled the parties' involvement in the scheme, and provided exhibits that detailed how Defendants acted in "secrecy, haste, and concealment."<sup>43</sup> Further, the Court noted that the Complaint adequately alleged the parties' intent with the expressed goal of "shielding DSI Renal assets from creditors, and is supported by reference to numerous internal documents belonging to the DSI entities...detailing the relevant transfers."<sup>44</sup>

### 2. Breach of Fiduciary Duties

First, the Trustee claimed Defendants acted with gross negligence and breached their duty of loyalty. The Trustee claimed Defendants did not obtain the highest value available for the company during the sales process. During the sale process, Defendants based the company's value on poor performance projections rather than its recent positive quarters. Additionally, the Trustee alleged Defendants acted in self-interest by "stripping DSI Holding/DSI Renal Holdings of its only asset, leaving it an empty shell, and profiting individually from their actions."<sup>45</sup> The Court held that the Trustee's allegations supported an inference that Defendants breached their fiduciary duties.

Next, the Trustee claimed the Centre Defendants owed fiduciary duties to the Debtors because they exercised control over the business affairs of the companies. Specifically, the complaint

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<sup>40</sup> *Id.* at 6.

<sup>41</sup> *Id.* at 3.

<sup>42</sup> *Id.* at 11.

<sup>43</sup> *Id.*

<sup>44</sup> *Id.* at 12.

<sup>45</sup> *Id.* at 16.



alleged the Centre Defendants held four out of five seats on the board for DSI Holding and the Debtors, and the Centre Defendants oversaw the termination of the sales process. The Court held that the Trustee sufficiently alleged the Centre Defendants “worked together as one entity and exercised control over the Debtors, specifically as to driving the DSI restructuring.”<sup>46</sup>

### 3. Aiding and Abetting the Breach of Fiduciary Duty

The Trustee must have established “(1) the existence of a fiduciary relationship, (2) a breach of the fiduciary’s duty, (3) knowing participation in that breach by the defendants, and (4) damages proximately caused by the breach.”<sup>47</sup> The Trustee alleged that NML Defendants, Ares, and Apollo knew the DSI restructuring was completed in order to “isolate the Renal Business and leave behind DSI Renal Holdings/DSI Holding’s liabilities”<sup>48</sup> The Court denied Defendants’ motion to dismiss, noting that the Trustee sufficiently alleged facts to support a reasonable inference of aiding and abetting.

### 4. Corporate Waste

The Complaint alleged D & O and Centre Defendants were liable for corporate waste. Centre Defendants, as well as D & O Defendant Yalowitz, argued that only directors were liable for corporate waste, and the Complaint did not list them as directors. Defendants cited to *Walt Disney Co. Derivative Litig.*, which noted, “[a] claim of waste will arise only in the rare, ‘unconscionable case where directors irrationally squander or give away corporate assets.’”<sup>49</sup> The Trustee did not cite to any case law that opposed the *Walt Disney* holding. The Court dismissed the count against Centre Defendants and Yalowitz.

The other D & O Defendants argued that the Complaint did not allege facts showing a complete failure of consideration in the DSI restructuring transaction, which was required to prove corporate waste. The Court denied the Defendants’ motions to dismiss, noting that the claim “adequately alleges that the Debtor’s transfer of its interest in DSI Renal served no rational business purpose”<sup>50</sup>

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<sup>46</sup> *Id.* at 17.

<sup>47</sup> *Id.* at 18.

<sup>48</sup> *Id.* at 19.

<sup>49</sup> 906 A.2d 27, 74 (Del.2006) (quoting *Breton v. Eisner*, 746 A.2d 244, 263 (Del. 2000).

<sup>50</sup> No. 11-11722 (KJC), 2017 WL 3105842, at \*20.



*In re Adelpia Communications Corp.*, 652 Fed. Appx. 19 (2d Cir. 2016).

**THE DISTRICT COURT DID NOT ERR IN FINDING THE DEBTOR'S ASSETS WERE NOT UNREASONABLY SMALL AT THE TIME OF THE CHALLENGED TRANSFER.**

*Recovery Trust brought a claim to set aside a stock repurchase transaction as constructively fraudulent to creditors. The US Bankruptcy Court for the Southern District of New York rejected the Trust's claims. This Court affirmed, finding that the debtor's assets were not unreasonably small at the time of the transfer.*

This claim arose out of the Chapter 11 reorganization of Adelpia Communications Corp. (“Adelpia”). Appellant, Adelpia Recovery Trust (“Recovery Trust”), sought to recover an alleged fraudulent transfer of some \$150 million paid by Adelpia to Appellees, FRP Group, Inc. and West Boca Security, Inc. for the repurchase of Adelpia’s own stock.

**Fraudulent Conveyance**

The stock repurchase was constructive fraudulent conveyance, if: “(1) the property is transferred for less than fair consideration and (2) either (a) the debtor was insolvent on the date of the transfer or (b) the debtor’s remaining assets were unreasonably small in relation to the transaction.”<sup>51</sup> The issue before the appeals court was whether the district court erred in finding that Adelpia’s assets were not unreasonably small at the time of the transfer.

“Unreasonably small” has not been defined by the Pennsylvania Uniform Fraudulent Transfer Act, but courts have interpreted it to describe a situation where “a transaction leaves a debtor technically solvent but doomed to fail.”<sup>52</sup> The courts have adopted a test that focuses on reasonable foreseeability, and “is satisfied if at the time of the transaction the debtor had such minimal assets that insolvency was inevitable in the reasonably foreseeable future.”<sup>53</sup> In order to determine the reasonable foreseeable future of Adelpia, courts look to various factors including Adelpia’s “debt to equity ratio, its historical capital cushion, and the need for working capital in the specific industry at issue.”<sup>54</sup>

Recovery Trust argued that the district court “improperly conflated its analysis of Adelpia’s solvency with its evaluation of whether Adelpia had unreasonably small capital.”<sup>55</sup> The Court rejected this argument, noting that the concepts are “conceptually distinct,” but they do overlap. Additionally, in holding that “the district court did not err in considering whether the challenged transaction left the debtor with unreasonably small capital in conjunction with whether it rendered

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<sup>51</sup> 12 Pa. Cons. Stat. § 5104(a)(2).

<sup>52</sup> *Moody v. Sec. Pac. Bus. Credit, Inc.*, 971 F.2d 1056, 1070 (3d Cir. 1992).

<sup>53</sup> *Id.* at 1073.

<sup>54</sup> *MFS/Sun Lite Tr.-High Yield Series v. Van Dusen Airport Services Co.*, 910 F. Supp. 913, 944 (S.D.N.Y. 1995).

<sup>55</sup> *In re Adelpia Communications Corp.*, 652 Fed. Appx. 19, 22 (2d Cir. 2016).



the company insolvent,”<sup>56</sup> this Court noted that adequacy of capital is a large component of any solvency analysis.

Next, Recovery Trust alleged that Adelpia’s financial condition had deteriorated, noting that “Adelpia had exceeded its maximum leverage ratio under its debt instruments as of January 1999, that it had a negative cash flow, that it was beset by ongoing fraud within the company, and that it was already in default under its existing bond indentures.”<sup>57</sup> Both the bankruptcy and district court found that even when considering this, “Adelpia could have sold off enough of its assets or alternatively obtained sufficient credit to continue its business for the foreseeable future.”<sup>58</sup> The Court held that the district court did not err in rejecting Recovery Trust’s argument.

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<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> *Id.*



*In re SemCrude L.P.*, 648 Fed. Appx. 205 (3d. Cir. 2016)

**DEBTOR'S EQUITY DISTRIBUTIONS TO ITS PRINCIPAL DID NOT LEAVE IT WITH UNREASONABLY SMALL CAPITAL.**

*A Trustee sought to avoid, as constructively fraudulent transfers, equity distributions of more than \$55 million that the debtor had made to its principal. The Court affirmed the lower court's judgment, noting that the transfers did not leave the debtor with unreasonably small capital, and were not considered constructively fraudulent.*

SemGroup, L.P (“SemGroup”) was an energy company that filed for bankruptcy in 2008. SemGroup’s business consisted of transportation, storage, and distribution of oil and gas products. Additionally, SemGroup traded options on oil-based commodities. To keep the business well financed, SemGroup relied on credit facilities for capital. From 2005 through July 2008, SemGroup had a credit line from over 100 different lenders (“Bank Group”). The credit was secured through a credit agreement in which SemGroup agreed not to trade naked options. After the credit agreement was signed, SemGroup continued to trade naked options<sup>59</sup>, in violation of the agreement. Additionally, SemGroup would make payments to fund trading losses incurred by Westback Purchasing Company, which was owned by SemGroup’s CEO.

Due to the volatile oil prices in 2007 and 2008, SemGroup was required to post larger margin deposits, which meant it had to increase its credit line. SemGroup’s borrowings grew from \$800 million to over \$1.7 billion. The Bank Group declared SemGroup in default of its credit line, and SemGroup declared bankruptcy in July 2008.

The Trustee alleged two claims against SemGroup equity holders, seeking to avoid equity distributions approved by SemGroup’s management: “(1) SemGroup was left with unreasonably small capital after the equity distributions; and (2) SemGroup was insolvent on the date of the 2008 distributions.”<sup>60</sup> The Bankruptcy Court denied the Trustee’s claims and the District Court affirmed.

**I. Unreasonably Small Capital Claims**

A transaction was deemed constructively fraudulent if it can be shown that the debtor, “(1) received less than a reasonably equivalent value in exchange for such transfer or obligation; and (2) was engaged in...a transaction...for which any property remaining with the debtor was an unreasonably small capital.”<sup>61</sup> The Court analyzed whether SemGroup was left with unreasonably small capital, following equity distributions.

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<sup>59</sup> Seller of an option does not own any, or enough, of the underlying security to act as protection against adverse price movement.

<sup>60</sup> *In re SemCrude L.P.*, 648 Fed. Appx. 205, 208 (3d. Cir. 2016).

<sup>61</sup> *Id.* at 209.



The Trustee alleged that it was reasonably foreseeable that SemGroup would lose its access to its line of credit because its trading strategy violated the credit agreement. This Court rejected that argument. In its reasoning, the Court followed the District Court and Bankruptcy Court, which reasoned that the “Trustee’s argument rested upon conjecture biased by hindsight such that it was not reasonably foreseeable that SemGroup would lose access to credit when it made the challenged equity distributions.”<sup>62</sup>

## II. Insolvency Claims

Next, the Trustee challenged the equity distribution as constructively fraudulent, noting that SemGroup was insolvent at the time of the distribution. The Trustee could have voided the equity distribution if it was shown SemGroup, “voluntarily or involuntarily...received less than a reasonably equivalent value in exchange for such transfer or obligation;” and “was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation.”<sup>63</sup>

The Trustee contended that SemGroup’s expert, Lederman, improperly relied on a June 2008 valuation prepared by Goldman Sachs regarding the solvency of the company, and it should not be accepted evidence. The Court rejected the Trustee’s argument, holding that the Goldman Sachs valuation report captured the marketplace value. Additionally, the Court noted that “Lederman explained the reasons for his reliance on the Goldman Sachs analysis; and Lederman then adjusted the Goldman Sachs valuation based on his own analysis and judgment while giving cogent reasons to support his conclusions.”<sup>64</sup>

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<sup>62</sup> *Id.* at 210.

<sup>63</sup> 11 U.S.C § 548(a)(1)(B)(ii)(I).

<sup>64</sup> 648 Fed. Appx. 205, 214 (3d. Cir. 2016).



*In re Lyondell Chem. Co.*, 554 B.R. 635 (S.D.N.Y. 2016)

**TRUSTEE’S ALLEGATIONS WERE INSUFFICIENT TO DEMONSTRATE THAT PRE-MERGER DIRECTORS HAD AN ACTUAL INTENT TO HINDER, DELAY OR DEFRAUD CREDITORS BY THEIR ACTIONS.**

*The Trustee sought to avoid and recover shareholder distributions made by an acquiring company about two weeks before closing of the merger by means of a leveraged buyout that had allegedly left debtors insolvent or inadequately capitalized. Notably, the Court reinstated the intentional fraud claim.*

Lyondell was a publicly traded petrochemicals company based in the US. The board of directors (the “Board”) consisted of the Lyondell CEO, Dan Smith (“Smith”), and ten outside directors. Lyondell’s unsecured creditors, though their Trustee, sought for reinstatement of their claim that Lyondell engaged in intentional fraudulent transfer in connection with a leveraged buyout (“LBO”). Additionally, the claim sought to regain \$6.3 billion in distributions made to Lyondell shareholders through the LBO.

In 2006, Lyondell purchased a 100% stake in an oil refinery on the Gulf Coast near Houston, Texas (“Houston Refinery”). Prior to the purchase, Lyondell and CITGO Petroleum Corporation operated the Houston Refinery as a joint venture.

During Lyondell’s purchase of the Houston Refinery, investor Leonard Blavatnik (“Blavatnik”), expressed interest in acquiring Lyondell. Blavatnik made an initial offer to acquire Lyondell in August 2006, but the Board rejected his offer of \$26.50 per share.

In May 2007, Blavatnik purchased 10% of Lyondell stock and looked to acquire the remaining 90%. With an acquisition imminent, Smith told Robert Salvin (“Salvin”), Lyondell’s Manager of Portfolio Planning, to come up with a series of refreshed EBITDA projections for 2007-2011. The Trustee alleged that Salvin improperly included an additional \$2 billion in the EBITDA, based on Smith’s instructions.

In June 2007, negotiations between Smith and Blavatnik began. The Board reviewed the inflated EBITDA projections and Lyondell’s financial advisor found that the merger was fair, and adopted management’s new projections. The merger closed in December 2007 at \$48 per share. Lyondell merged with Basell AF S.C.A and was known as LyondellBasell Industries (“LBI”).

In February 2008, LBI suffered from “negative liquidity, lower oil prices, and other adverse developments.”<sup>65</sup> Lyondell filed for bankruptcy in January 2009.

This Court reversed the Bankruptcy Court’s decision and reinstated the intentional fraudulent conveyance claim.

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<sup>65</sup> *In re Lyondell Chem. Co.*, 554 B.R. 635, 642 (S.D.N.Y. 2016), reconsideration denied sub nom. *In re Lyondell Chem. Co.*, 16CV518 (DLC), 2016 WL 5818591 (S.D.N.Y. Oct. 5, 2016).

## Imputation

“An employee’s knowledge can be imputed to her employer if she becomes aware of the knowledge while she is in the scope of employment, her knowledge pertains to her duties as an employee, and she has the authority to act on the knowledge.”<sup>66</sup> To determine whether Smith’s conduct was within the scope of his employment, the Court looked to four elements:

1. Is it of the kind he is employed to perform;
2. It occurs within the authored time and space limits;
3. It is activated, in part at least, by a purpose to serve the master; and
4. If force is used, the use of force is not unexpected by the master.<sup>67</sup>

The Court held that Smith’s knowledge and intent in connection with the LBO may be imputed to Lyondell. In its decision, the Court noted that Smith was an agent of the company, he supervised and directed the preparation of the revised EBITDA projections, and he negotiated the merger with Blavatnik on behalf of the corporation.

## Lyondell’s Actual Intent

For the Trustee to prove actual intent, he must demonstrate “actual intent to hinder, delay, or defraud any entity to which the debtor was or became...indebted.”<sup>68</sup> Additionally, the debtor’s actual intent “need not target any particular entity or individual as long as the intent is generally directed toward present or future creditors of the debtor.”<sup>69</sup>

To assist in proving actual intent, the Trustee could rely on badges of fraud to support his case. The Trustee successfully pleaded the following badges:

1. The transfer or obligation was to an insider;
2. The transfer was of substantially all the debtor’s assets; and
3. The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred.<sup>70</sup>

“While the presence of a single badge of fraud may spur mere suspicion, the confluence of several can constitute conclusive evidence of an actual intent to defraud, absent ‘significantly clear’ evidence of a legitimate supervening purpose.”<sup>71</sup>

The Court held that the Trustee had “pleaded facts sufficient to create a strong inference that Smith acted with actual intent to hinder, delay, and defraud Lyondell’s creditors.”<sup>72</sup> In its reasoning, the Court noted that Smith helped create, without any justification, an inflated set of financial projections. “Smith knew that the refreshed projections were materially inflated and unjustified,

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<sup>66</sup> *Id.* at 647.

<sup>67</sup> *Id.* at 648.

<sup>68</sup> *Id.* at 649.

<sup>69</sup> *In re Bayou Group, LLC*, 439 B.R. 284, 304 (S.D.N.Y. 2010).

<sup>70</sup> *In re Lyondell* 2016 WL 5818591 at 652.

<sup>71</sup> *Id.* at 653; see also *Max Sugarman Funeral Home, Inc., v. A.D.B. Inv’rs*, 926 F.2d 1248, 1255 (1st Cir. 1991).

<sup>72</sup> *Id.* at 654.



but presented them to the Lyondell Board and caused them to be presented to Blavatnik’s representatives and to the Lender Banks.”<sup>73</sup> Accordingly, the Trustee pleaded sufficient facts, where it could have been properly inferred that Smith acted with reckless disregard towards creditors, and, “also contemplated and believed that Lyondell would default on its obligations to its creditors within a very short period of time.”<sup>74</sup>

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<sup>73</sup> *Id.*

<sup>74</sup> *Id.*



*In re Princeton Paper Products, Inc.* (2015)

**THE COURT HELD THAT THE TRANSFERS MADE BY PRINCETON WERE CONSTRUCTIVELY FRAUDULENT.**

*The Trustee alleged that the Defendants fraudulently transferred assets to themselves, and the transfers referred to two account receivables that were removed from the Debtor's books before the involuntary Chapter 7 filing. The Court held that the Trustee was entitled to the value of the avoided transfers.*

In 2006, Princeton Paper Products, Inc. (“Debtor”) was formed in New Jersey, in order to manufacture pizza boxes. Gil Korine (“Defendant”) was the sole owner of Princeton, as well as separate entities, Freeport Paper, Avco, and Westco.

Before bankruptcy, the Debtor sold all pizza boxes it made to Freeport Paper, who then sold the boxes to distributors. To make the boxes, the Debtor leased a box manufacturing machine from Westco, which had been bought from 48 Hour Sheet LLC for \$300,000. Though this purchase was titled under Westco’s name, the Debtor funded the purchase price, which included “(i) a \$125,000.00 down payment taken from the Avco loan proceeds, and (ii) an independent loan to Westco in the amount of \$175,000.00.”<sup>75</sup> Through the lease, the Debtor would make payments to Westco at \$30,000 per month for 31 months. Ultimately, the Debtor only made five monthly payments.

The Debtor purchased rolls of paper to be used in the box manufacturing machine from three different suppliers, Central National-Gottesman, Inc.; King Paper; and Fiber Net, LLC. The Debtor owed these suppliers \$2,060,080.89.

In April 2009, three of the Debtor’s creditors (“Trustee”) filed an involuntary Chapter 7 bankruptcy petition against the Debtor. The Trustee claimed that the Debtor had transferred substantial funds to its principal, Defendant Korine. The Trustee pointed to two accounts that were removed from the Debtor’s books prior to the involuntary Chapter 7 filing. First, the Trustee noted a receivable of \$740,722.00 being due from Freeport Paper on its 2007 and 2008 tax returns. Second, the Trustee pointed to \$524,595.67 that was due from Westco on the 2007 year-end books of the Debtor and the 2008 tax return.

### **Fraudulent Transfers as to Freeport Paper and Westco**

The Trustee claimed that elimination of these two receivables constituted constructive fraudulent transfers. Under the New Jersey Uniform Fraudulent Act § 25:2–27(a), constructive fraud was defined as:

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<sup>75</sup> *In re Princeton Paper Products, Inc.*, 09- 19782, 2015 WL 9700940, at \*2 (Bankr. D.N.J. Nov. 6, 2015).



A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at the time or the debtor became insolvent as a result of the transfer or obligation.

In order to recover a constructively fraudulent transfer, the plaintiff must have established that (i) the debtor had an interest in the property; (ii) the transfer occurred within 2 years of the petition; (iii) the debtor was insolvent at the time of the transfer or became insolvent because of the transfer; and (iv) the debtor received less than a reasonable value in exchange for the transfer.<sup>76</sup>

### I.

To prove the first element, the Trustee must have shown that the Debtor transferred an interest in property. An interest was defined as “each mode, direct or indirect, absolute or conditional, voluntary or involuntary, or disposing of or parting with (i) property; or (ii) an interest in property.”<sup>77</sup> The Court held that the Trustee satisfied the first element, noting that “the presence of these receivables on the Debtor’s ledgers represented assets that would have been available to the bankruptcy estate had they not been eliminated as part of the restructuring undertaken by Debtor’s accountant on the eve of bankruptcy.”<sup>78</sup>

### II.

Next, the Court decided whether the transfer occurred within two years of the bankruptcy filing. The Court ruled that this element was satisfied, noting that the involuntary petition was filed on April 20, 2009 and the two receivable accounts were from 2008.

### III.

The third element inquired into the Debtor’s financial state at the time of the transfer. Insolvent was defined as a “financial condition such that the sum of such entity’s debts is greater than all of such entity’s property, at fair valuation...”<sup>79</sup> The Debtor admitted that it was unable to pay its debts as of September 2008. The Court held that the third element was satisfied, noting that the transfers rendered the Debtor insolvent, “as the Debtor went from having approximately \$1,200,000.00 in receivables on its books when it filed its tax returns in 2008, to ceasing operations due to an inability to pay debts in September of the same year.”<sup>80</sup>

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<sup>76</sup> *Id.* at 6.

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

<sup>79</sup> *Id.* at 7.

<sup>80</sup> *Id.*

#### IV.

Finally, the Trustee had to establish that the Debtor did not receive a reasonably equivalent value in return for the transfer. Although the Bankruptcy Code did not define reasonably equivalent value, the Third Circuit noted that “a party receives reasonably equivalent value for what it gives up if it gets roughly the value it gave.”<sup>81</sup> The Court considered whether the transfer was “legitimate and reasonable to expect some value accruing to the debtor, in determining whether the debtor received any value at all.”<sup>82</sup> The Court held that the fourth element was satisfied, noting that the Debtor did not receive any value at all for the two receivables at issue.

#### Conclusion

The Court ruled in favor of the Trustee in the amount of (i) \$740,722.00 against Freeport Paper and (ii) \$524,595.67 against Westco.

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<sup>81</sup> *In re Autobacs Strauss, Inc.*, 473 B.R. 525, 568 (Bankr.D.Del.2012)

<sup>82</sup> 09-19782, 2015 WL 9700940, at \*7 (Bankr. D.N.J. Nov. 6, 2015).



*In re Dressel Associates, Inc.*, 536 B.R. 158 (W.D. Pa. 2015).

**TRUSTEE WAS NOT ABLE TO DEMONSTRATE DEBTOR’S INSOLVENCY IN ORDER TO ESTABLISH A FRAUDULENT TRANSFER CLAIM.**

*The Debtor was liable for \$20 million, which was shared with other entities. Five transfers were made to various entities, including Midtown. The Trustee discovered these transfers and filed a complaint, alleging that the transfers were fraudulent. The Court denied the Trustee’s claim, noting that the Debtor relied on accurate financial schedules before considering the transfers.*

Before filing for bankruptcy, Dressel Associates, Inc. (“Debtor”) was liable for \$20 million, which was shared with other entities owned by Gary Reinert. On July 15, 2010, between the date of the district court judgment and the date of the bankruptcy filing, \$924,728.70 was deposited into the Debtor’s bank account. Subsequently, four additional transfers were made on July 16, 2010, totaling \$924,728.69. A transfer of \$412,579.00, which was the transfer at issue, was made to Midtown. Subsequently, Midtown transferred \$230,195.00 and \$186,785.00, respectively, to REA Modesto, LP and Bashmart, LLC. The Trustee claimed the transfer of funds from Debtor’s accounts were fraudulent.

To prove a claim of constructive fraudulent transfer, § 548(a)(1)(B) required a Trustee to establish “(1) the debtor had an interest in property; (2) a transfer of that interest occurred within one year of the bankruptcy filing; (3) the debtor was insolvent at the time of the transfer or became insolvent as a result of the transfer; and (4) the transfer resulted in no value for the debtor or the value received was not ‘reasonably equivalent’ to the value of the relinquished property interest.”<sup>83</sup> The Court began its analysis with the third element, noting that the bankruptcy court focused on Trustee’s failure to provide proof of insolvency.

**Fraudulent Conveyance**

Insolvency was defined as the “financial condition such that the sum of such entity’s debts is greater than all of such entity’s property, at fair valuation.”<sup>84</sup> Where bankruptcy is not clearly imminent, fair valuation is determined on a going concern basis.

The Trustee alleged that evidence was admitted that would be able to satisfy the elements necessary to show the existence of a constructive fraudulent transfer. In support of this argument, the Trustee set forth three main points. (i) Mr. Shearer’s Testimony that the financial schedules were as accurate as possible under the circumstances and that Debtor’s assets were combined with those of several other entities and together sold for only \$5 million; (ii) Mr. McMillan’s testimony that he believed the Debtor’s financial condition to have been consistent from the time of the transfers to the time of Debtor’s bankruptcy filing; and (iii) the \$20 million judgment owed jointly

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<sup>83</sup> *In re Dressel Associates, Inc.*, 536 B.R. 158, 164 (W.D. Pa. 2015).

<sup>84</sup> 11 U.S.C. § 101(32)(A).



and severally to Fifth Third Bank by Debtor and at least five other entities predated the alleged fraudulent transfers.

The Court rejected Trustee’s first argument, noting that financial schedules “as accurate as they can reasonably be,”<sup>85</sup> does not mean that the financials are actually accurate. In support, the Court noted that the parties compiling the Debtor’s financials, “could not say whether generally accepted accounting principles were used...whether contingent liabilities were accounted for...and whether the asset valuations in the financial schedules reflected Debtor’s valuation as an ongoing concern.”<sup>86</sup>

The Court rejected Trustee’s second argument, opining that the accuracy of the financial schedules “does not bolster the schedules’ reliability for purposes of determining Debtor’s insolvency at the time of the relevant transfers.”<sup>87</sup>

Finally, the Court rejected Trustee’s last argument, noting that, under the legal doctrine of joint and several liability, Debtor may have been liable for the entire \$20 million judgment, which predated the alleged fraudulent transfers at issue, but there was no testimony or evidence set forth that would have made this true.

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<sup>85</sup> 536 B.R. 158, 165 (W.D. Pa. 2015).

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*



*In re Vivaro Corp.*, 524 B.R. 536 (Bankr. S.D.N.Y. 2015)

**THE COURT REJECTED THE CREDITORS' FRAUDULENT CONVEYANCE CLAIM, NOTING THAT THE CREDITORS FAILED TO SUFFICIENTLY ALLEGE STI'S INSOLVENCY OR UNREASONABLY SMALL CAPITAL.**

*A committee of creditors brought this proceeding to avoid obligations and transfers under fraudulent transfer provisions of the Bankruptcy Code and Defendants moved to dismiss the claims. The Court held that the allegations forwarded by the creditors did not allege STi's unreasonably small capital at the time of the transfers.*

Vivaro Corporation, STi, Kare Distribution, Inc., STi Telecom, Inc., TNW Corporation, STi CC1, LLC, and STi CC 2, LLC (collectively, "Debtors" and "Plaintiffs") filed petitions for relief under chapter 11 of the Bankruptcy Code. The Complaint challenged two fraudulent conveyances. "(1) transfers in 2007 and 2008 from Debtor STi to Defendant Baldwin ("STi Transfers"), and (2) payments to Debtors Vivaro and STi to Baldwin in connection with Vivaro's acquisition of membership interests in STi."<sup>88</sup>

### **Corporate Structure**

Leucadia is the top of the corporate structure, while Phlcorp is second in line, a wholly-owned subsidiary of Leucadia. Baldwin is third, as a wholly-owned subsidiary of Phlcorp.

### **The Transfers**

In 2007, Leucadia entered into a deal with Telco Group, Inc. ("Telco") in which Leucadia purchased Telco's prepaid calling card business. In 2007, Leucadia indirectly owned 75% of STi, and STi purchased a 75% interest in Telco. In 2007, STi was an LLC with two members: BEI Prepaid and ST Finance.

After STi purchased Telco, STi made transfers directly to Baldwin, which was allegedly a Colorado corporation and wholly-owned by Leucadia. The transfers included: a \$15 million transfer to Baldwin Enterprises; a \$12 million transfer to Baldwin in November 2007; a \$5 million transfer to Baldwin in July 2008; and a \$5 million transfer to Baldwin Enterprises, Inc.

The Complaint alleged that STi was insolvent at the time the November 2007 transfer was made to Baldwin, and that by the time the July 2008 transfer was made to Baldwin, STi had sunk even further into insolvency.

### **Acquisition Payments**

In 2010, Vivaro acquired STi from Baldwin for \$20 million. Vivaro made an initial cash payment, and entered a repayment schedule, where Vivaro was obligated to pay Baldwin monthly

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<sup>88</sup> *In re Vivaro Corp.*, 524 B.R. 536, 542 (Bankr. S.D.N.Y. 2015).



installments of \$600,000. The Complaint contended that the Debtors' books and records indicated that "both on a standalone entity and on a consolidated basis, Vivaro and STi were both insolvent at the time of the acquisition and thereafter."<sup>89</sup> Additionally, the Complaint alleged that Vivaro was unable to make payments as scheduled, and as guarantor of the payments, STi had to fund the payments. After continuously falling behind on the payment schedule to Baldwin, STi entered into an agreement with The Receivables Exchange, in order to fund the payments.

The Complaint alleged six causes of action: (1) avoidance of the STi transfers as fraudulent conveyance; (2) avoidance of Vivaro's payment schedule as a fraudulent obligation; (3) avoidance of STi's guarantee obligation as a fraudulent obligation; (4) avoidance of the scheduled payments as fraudulent transfers; (5) recovery of property; and (6) avoidance and recovery of the STi transfers as actual fraudulent transfers.<sup>90</sup>

### **Count I**

Plaintiffs were required to plead both fair consideration and insolvency in order to assert a claim of fraudulent conveyance. The Court looked towards a balance sheet test, where the Court can assess whether the corporation's liabilities exceeded their assets at the time of the transfer. In support, the Plaintiff noted that STi was in financial decline and was insolvent as of June 2007. The Court held that the Complaint adequately alleged that "there was no legitimate purpose for the STi Transfers other than to benefit Defendants."<sup>91</sup> Additionally, the Court held that the Complaint set forth allegations regarding STi's assets were less than its liabilities, but the allegations "merely provide 'negative equity' figures and asset that the deficit demonstrates STi's insolvency at the time the second two STi transfers were made."<sup>92</sup> Therefore, the Court granted Defendant's motion to dismiss, with leave to amend.

### **Count VI**

Defendants alleged that the Complaint did not adequately allege STi's insolvency, and an "intent to hinder, delay, or defraud"<sup>93</sup> creditors. The Complaint alleged two badges of fraud, which included "(1) allegations that STi was insolvent at the time the STi Transfers were made, though only in June and November 2007; and (2) allegations of the existence or cumulative effect of a series of transactions or course of conduct after the onset of financial difficulties."<sup>94</sup> The Court held that the Complaint did not provide allegations to sufficiently allege badges of fraud with particularity. The Court dismissed Count VI without prejudice.

### **Counts II, III, and IV**

Defendants argued that the Complaint failed to adequately allege that "(1) the Debtors did not receive reasonably equivalent value or fair consideration in exchange for the payments made and

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<sup>89</sup> *Id.* at 544.

<sup>90</sup> *Id.* at 545.

<sup>91</sup> *Id.* at 549.

<sup>92</sup> *Id.* at 553.

<sup>93</sup> *Id.*

<sup>94</sup> *Id.* at 554.



obligations incurred, and (2) Vivaro and STi were insolvent at the time the acquisition occurred and the challenged payments were made.”<sup>95</sup> The Court dismissed Counts II and IV, noting that the Plaintiff provided conclusory allegations without providing any proof regarding the acquisition. Next, the Court dismissed Count III. The Complaint stated that “STi did not receive reasonably equivalent value or fair consideration in exchange for STi’s obligation under the Guaranty...”<sup>96</sup> The Court held that the Complaint failed to include actual financial or balance sheet information in the Complaint. Further, the Court noted that the Complaint consisted of conclusory allegations, without providing underlying financial figures in support.

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<sup>95</sup> *Id.* at 555.

<sup>96</sup> *Id.* at 558.



*In Re: Tribune Company, et. al.*, No. 08-13141 (Bankr. D. Del. 2011)

**DESPITE FLAWS IN THE PROCUREMENT OF A SOLVENCY OPINION, THE COURT EXAMINER FINDS THAT STEP ONE OF A LEVERAGED BUYOUT NOT LIKELY TO BE A FRAUDULENT CONVEYANCE**

*In Re Tribune Company, the Court found that despite flaws surrounding the procurement of a solvency opinion, that Step One of the LBO, while highly leveraged, was “not likely” to be found by a court to be a fraudulent conveyance. However, a court would be “somewhat likely” to find that Step Two was an intentional fraudulent transfer.*

**Initial Transaction:**

- In 2007, Sam Zell closed a two-step leveraged buyout (“LBO”) of the Tribune Company, a publishing and media conglomerate, owner of the Los Angeles Times and the Chicago Tribune, with minority interests in private entities such as the TV Food Network.
- In “Step One” of the LBO, a Zell-controlled trust sold the company to an employee stock ownership plan (“ESOP”), leveraged with \$8.2 billion of senior secured financing. “Step Two” consisted of a merger that added another \$3.7 billion in debt, cancelled all issued and outstanding shares of Tribune stock, and left the ESOP as sole owner of the new entity.
- On December 8, 2008, within a year of the going-private transaction, the Tribune and its related entities filed for Chapter 11 bankruptcy relief.

**Background of the Court Case:**

- From the outset of the bankruptcy, the resolution of certain LBO-related claims became central to the formulation of any reorganization plan. These consisted primarily of the debtors’ claims to avoid the LBO as a fraudulent conveyance; that is, that either or both steps of the transaction took place when the debtors were insolvent or left them insolvent.
- By April 2010, the debtors had proposed a plan of reorganization, but, given the complexity of the LBO claims, the bankruptcy court deferred its hearing on the plan and appointed an independent examiner to investigate the validity and potential value of the LBO claims.
- The examiner subsequently developed a comprehensive financial analysis, including issues concerning the debtors’ solvency, its available capital at the time of the two-part transaction, and the flow of funds among the various entities. The examiner also evaluated a solvency opinion conducted by Tribune Company’s financial advisor, which concluded that the debtors could meet their obligations under the heavily leveraged buyout.
- Although the examiner found flaws with the process surrounding the procurement of the solvency opinion, the examiner concluded that Step One of the LBO was not likely to be found by a court to be a fraudulent conveyance.
- As a result, the debtors abandoned their original proposal while other parties considered a competing plan.



*In Re Premier Entertainment Biloxi LLC* 2010 W L 3504105 (Bkrcty. S.D. Miss)

**BANKRUPTCY COURT PREFERS ADJUSTED BALANCE SHEET TEST, INCLUDING FMV OF BRAND LICENSE**

*In Re Premier Entertainment, the Court ruled the “equitable insolvency test” did not apply and instead found the adjusted balance sheet was “the traditional bankruptcy test of insolvency.” Further, the Court found that the adjustments by the note holders’ expert were appropriate - in particular, his use of the market values rather than book values of assets.*

**Initial Transaction:**

- In 2002, Premier Entertainment Biloxi LLC (“Premier”) began constructing the Hard Rock Hotel and Casino Biloxi, a full-service gaming resort. To underwrite construction, Premier entered into an indenture agreement by which it pledged over \$160 million in first lien mortgage notes secured by the resort’s assets and supervised by U.S. Bank as trustee. To protect the note holders against prepayment, the indenture agreement precluded the debtors from redeeming the notes unless they paid a liquidated damages premium.

**Background of the Court Case:**

- To prepare for the resort’s grand opening, Premier procured over \$181 million of insurance in August 2005. Shortly thereafter, a hurricane completely destroyed the casino and severely damaged the hotel. Premier eventually recovered the \$181 million of insurance proceeds and delivered them to the indenture trustee on behalf of the note holders.
- After filing its petition, Premier proposed to pay the notes at par value plus interest, thereby extinguishing the note holders’ liens and releasing the insurance proceeds. The note holders opposed the plan because it did not provide for a prepayment penalty pursuant to the indenture agreement.
- Due to the dispute, Premier ultimately filed for Chapter 11 bankruptcy relief (in 2006), in part because it could not get access to the funds to finish construction.
- In court, Premier insisted it was “equitably” insolvent as of the date of their bankruptcy petition, because without access to the insurance proceeds, they had only \$200,000 in cash and over \$230 million in outstanding liabilities. By contrast, the note holders claimed the debtors were solvent at all times, because “their debts never exceeded their assets, notwithstanding any perceived cash flow problems”.
- To show the latter, the note holders presented a valuation and solvency expert who reviewed Premier’s bankruptcy schedules, which showed nearly \$253 million in assets and only \$230 million in liabilities. The expert also provided an analysis using an asset



approach and a cost- based balance sheet prepared according to GAAP, but adjusted certain asset values to equate them with the Bankruptcy Code’s requirement of “fair valuation”.

- The court agreed with the note holders expert and found Premier to be solvent at all relevant times and awarded the note holders their unsecured claims for liquidated damages.



*Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, 2009 WL294935 (Cal. App. 2 Dist.)

**PESSIMISTIC ASSUMPTIONS, NO CONSULTATION WITH MANAGEMENT AND KNOWLEDGE OF POTENTIAL LITIGATION DOOM INSOLVENCY OPINION**

*The Court ruled an insolvency opinion as unreliable due to knowledge that [it] would potentially be used in litigation, was based on skewed numbers provided by [the buyer], and was produced without any consultation with [the seller's] management.*

**Initial Transaction:**

- In July 2007, Hexion Specialty Chemicals, Inc. agreed to acquire Huntsman Corp. for \$28 per share in an all-cash deal valued at approximately \$10.6 billion. To secure the deal, Hexion also agreed to stringent terms, including “no out” financing - even if financing fell through, it would still have to pay \$325 million in liquidated damages, unless it could show a “materially adverse effect” (MAE) to the seller’s business. Further, if the Hexion committed a “knowing and intentional breach” - including failure to use best efforts to consummate financing - the seller could sue for uncapped damages, including specific performance.

**Background of the Court Case:**

- While the parties were engaged in obtaining the necessary regulatory approvals, Huntsman reported several disappointing quarterly results, missing the numbers it projected at the time the deal was signed.
- As a result, Hexion began exploring options for extricating it from the transaction. At first, this process focused on whether the seller had suffered a material adverse effect. By early May, however, attention shifted to an exploration of the prospective solvency of the combined entity.
- Hexion then retained the services of a well-known valuation firm to explore the possibility of obtaining an opinion that the combined entity would be insolvent.
- After making a number of changes to the inputs into the deal model that materially and adversely effected the viability of the transaction, and without consulting with Huntsman about those changes or about other business initiatives that might improve the prospective financial condition of the resulting entity, the valuation firm did provide an “insolvency” opinion to Hexion.
- The insolvency opinion was later published in a press release claiming that the merger could not be consummated because the financing would not be available due to the prospective insolvency of the combined entity and because the seller had suffered a material adverse effect, as defined in the merger agreement.
- Because the insolvency opinion “was produced with the knowledge that [it] would potentially be used in litigation, was based on skewed numbers provided by [the buyer],



and was produced without any consultation with [the seller's] management," the court held that these factors, taken together, rendered the insolvency opinion "unreliable."



*North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 2007 Del. Lexis 227

**THE CREDITORS OF A CORPORATION THAT IS INSOLVENT OR IN THE ZONE OF INSOLVENCY CANNOT ASSERT A DIRECT CLAIM FOR BREACH OF FIDUCIARY DUTY AGAINST THE DIRECTORS OF THE CORPORATION**

*In North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, the Court decided that creditors of an insolvent corporation or one within the Zone of Insolvency cannot assert direct claims for breaches of fiduciary duties against the corporation. The Court reasoned that since there are already legal safeguards in place to protect the creditors, adding this additional duty upon the directors would conflict with the director’s already existing duties to the shareholders and the corporation.*

**Initial Transaction:**

- North American Catholic Educational Programming Foundation, Inc. (“NACEPF”), a holder of certain radio wave spectrum licenses regulated by the Federal Communications Commission (“FCC”), joined together with certain other Spectrum license holder to form the ITFS Spectrum Development Alliance, Inc. (the “Alliance”).
- In March of 2001, Clearwire Holdings, Inc. (“Clearwire”) entered into a Master Use and Royalty Agreement (the “Master Agreement”) with the Alliance to purchase the right to use the spectrum licenses for \$24,300,000.

**Background of the Court Case:**

- Subsequent to the agreement, Clearwire succumbed to financial pressures and filed for bankruptcy.
- NACEPF filed suit against certain directors of Clearwire (the “Defendants”) alleging claims of fraudulent inducement, tortious interference, and breaches of fiduciary duties.
- The Defendants moved to dismiss the Complaint for lack of personal jurisdiction and failure to state a cause of action under Delaware Court of Chancery Rule 12(b)(6). The Chancery Court granted the Defendant’s motion and NACEPF appealed.
- The matter on appeal is whether a corporation’s creditors may assert direct claims against directors for breach of fiduciary duties when the corporation is either insolvent or in the zone of insolvency.



- The Court found that recognition of a new right for creditors to bring direct fiduciary claims against directors of an insolvent company would create a conflict between the directors' duty to maximize the value of the insolvent corporation for the benefit of the shareholders, and the newly recognized direct fiduciary duty to individual creditors. The Court concluded that creditors can maintain derivative claims against directors of an insolvent corporation for breaches of fiduciary duties but had no right to assert direct claims against the directors.



*In Re: American Classic Voyages Co.*, 2007 Bankr. Lexis 1394

### **A VALUATION EXPERT WITH EXTENSIVE EXPERIENCE PROVIDES SUBSTANTIAL CREDIBILITY**

*A Court will consider many different factors when deciding which parties' solvency analysis to follow. The Court will look at the whether the experts were valuing the company as a going concern or on a liquidation valuation basis, the kind of approaches the expert employed and the experience each of the experts possesses. In Re American Classic Voyages Co., the Court analyzed the aforementioned but found the twenty years of experience that the defendant's expert had to be most persuasive.*

#### **Initial Transaction:**

- On September 8, 2000, AMCV decided to relocate to Sunrise, Florida, and build a new headquarters facility. AMCV obtained financing through a bank syndicate loan, for a revolving line of credit in the amount of \$70,000,000 ("Chase Facility"), which was later reduced to \$30,000,000. AMCV made withdrawals from the line of credit and the rest of the proceeds were held in a separate bank account untouched until August 14, 2001 ("Transfer Date"), the date on which the borrowing was repaid ("Transfer").

#### **Background of Court Case:**

- The events of September 11, 2001 ("9/11") had a devastating effect on AMCV's business. Despite actions taken in the summer of 2001 to improve its financial situation, AMCV filed for bankruptcy within a month after 9/11.
- AMCV brought this action to void the August 14, 2001 transfer made on behalf of the Chase Facility on the grounds of assumption that they were insolvent 90 days prior to filing for bankruptcy.
- The defendant hired an independent financial expert who concluded through thorough analysis, that AMCV was solvent on the date of transfers.
- AMCV retained its own independent financial expert and argued that the reports and projections which were prepared by AMCV and relied upon by the defendant's expert, were speculative and inconsistent with its past performance and current financial situation and therefore undermine the defendant's expert's entire solvency analysis.
- The Court found that while both the defendant's expert and AMCV's expert presented valid arguments to back up their solvency analysis, the Court was persuaded by the defendant's expert's extensive experience in performing valuations. He had twenty years of experience in the valuation field and had performed over 200 valuations. Therefore, the Court concluded that AMCV was solvent on the date of the transfers and its bankruptcy was caused by the unforeseen events of 9/11.



*In Re: Heilig-Meyers*, 319 B.R. 447 (Bankr. E.D. Va. 2004)

**TO PROVE INSOLVENCY UNDER THE BALANCE SHEET TEST METHODOLOGY, AN INDEPENDENT FINANCIAL OPINION IS NEEDED**

*In Re Heilig-Meyers*, the Court discussed the balance sheet test for insolvency in length. The Court expressed the need for expert financial opinions when determining whether a company is insolvent or not. The Court stated that the application of the balance sheet test for insolvency should not solely rely on asset book values contained in the debtors' financial statements or bankruptcy schedules. It should also rely on other sources of information including, but not limited to, expert financial opinions, such as solvency opinions, current audited financial statements, current business valuations and appraisals performed by independent experts and the debtor's actual operating experience.

**Initial Transaction:**

- Heilig-Meyers Company ("Heilig-Meyers"), the largest furniture retailer in the United States had approximately \$20,000,000 in antecedent debt. Due to financial pressures servicing the debt levels, Management requested modifications to its existing debt agreements.
- These modifications were executed on May 25, 2000. On August 16, 2000, Heilig-Meyers filed for bankruptcy and later sought to avoid the liens and related cash payments made to the lenders by Heilig-Meyers under the modified agreements on the grounds that they were insolvent at the time of the transactions.

**Background of the Court Case:**

- To determine the financial condition of Heilig-Meyers, the Court relied on a balance sheet test of insolvency which incorporates testimony of the parties' expert financial opinions, as well as a calculated dollar figure to arrive at its determination.
- Both parties retained financial opinion experts to perform valuation reports and support their findings through court testimony. The Court analyzed both parties' reports and concluded its own determination of solvency based on the expert's findings.
- The Court concluded that Heilig-Meyers was solvent on the date it executed the modifications and therefore the liens and cash payments are valid and not avoidable.



*Payless Cashways, Inc. v. Hitachi Power Tools*, 290 B.R. 447 (Bankr. D. MO 2003)

## **INVESTMENT BANKER'S ADVICE FALLS ON DEAF EARS RESULTING IN THE DEMISE OF PAYLESS CASHWAYS**

*In Payless Cashways, Inc. v. Hitachi Power Tools the management of, Payless Cashways, Inc., ("Payless") went against the advice of their investment banker and followed the suggestion of its lender to file for bankruptcy and avoid paying antecedent debts to its vendors. The Court concluded that Payless was not insolvent at the time it made the transfers to its vendors, because Payless was not on its deathbed and therefore should be valued as a going concern.*

### **Initial Transaction:**

- Payless, a building materials and finishing products specialty retailer, had emerged from bankruptcy pursuant to a Plan of Reorganization in November of 1997. By the end of 2000, Payless' net sales were the highest they had been in four years.
- Payless obtained an overline advance from Hilco Capital, L.P. ("Hilco") in the amount of \$15,000,000 during the slow season, in order to purchase inventory in anticipation of the busy spring season.

### **Background of the Court Case:**

- Due to circumstances surrounding the timing the loan from Hilco, Payless was unable to keep adequate inventory levels in its stores, as well as keep current on its payments to trade vendors.
- Starting in April of 2001, Hilco tightened its lending formula and by May of 2001, Hilco recommended that Payless file for bankruptcy. Hilco reasoned that Payless could use its cash to purchase new inventory rather than pay its vendors for merchandise that had already been shipped.
- Payless' investment banker advised against bankruptcy because it believed Payless was worth much more outside of bankruptcy. Nonetheless, in June of 2001, Payless filed for bankruptcy.
- Consequently, it appeared as though the investment banker was correct, as the filing of bankruptcy was devastating to Payless's customer base. By August of 2001, Hilco decided that Payless would have to be liquidated.
- The court-appointed liquidation trustee sought this action to avoid prior transfers to certain creditors on the grounds that Payless was insolvent 90 days prior to filing for bankruptcy.



- In order to determine the solvency of Payless, the Court relied on the information gathered by experts from both parties to construct the balance-sheet test. The trustee's expert valued Payless using a liquidation value and the defendant's expert used a going concern value. The Court decided to use the going concern values for its balance-sheet test because Payless was not on its deathbed and, therefore, not insolvent at the time of the transfers.



*In Re: Lids Corporation*, 281 B.R. 535 (Bankr. D. Del. 2002)

**THERE IS NO DEFINITIVE ACCOUNTING METHODOLOGY FOR DETERMINING THE SOLVENCY OF A COMPANY**

*It is a well-established precedent that there is no generally accepted accounting principle (“GAAP”) method for analyzing the insolvency of a company. However, in the case of In Re Lids, the Court found that the methodology and analysis employed by Houlihan Lokey Howard & Zukin (“HLHZ”) failed to establish the solvency of Lids Corporation (“Lids”) as of the Valuation Date. The Court stated that it was not convinced that HLHZ’s choice of multiples accurately reflected comparable companies’ values. Moreover, the Court found that HLHZ had improperly relied on the Lid’s projections to calculate value. Thus, the Court concluded that the presumption of insolvency was accurate as of the Valuation Date.*

**Initial Transaction:**

- In April of 1999, Lids executed a Warrant Purchase Agreement and a 12% Note for \$2,500,000 with Marathon Investment Partners, L.P. (“Marathon”).
- Shortly thereafter, Lids was in violation of numerous covenants with its lenders. In May of 2000, Lids requested Marathon to waive its defaults in exchange for a renegotiation of their prior debt agreements. On October 20, 2000 (“Valuation Date”), Marathon consented and raised the interest rate on the Note to 14% and was granted a security interest in all of Lids assets. However, by the beginning of 2001, Lids’ poor financial standing resulted in Lids filing for bankruptcy.

**Background of the Court Case:**

- In July 2001, Lids filed a Complaint to avoid the security interest granted to Marathon on the Valuation Date, claiming that it was insolvent at the time.
- Marathon retained HLHZ to do a financial analysis of Lids as of the Valuation Date.
- The Court found that HLHZ’s financial analysis was unconvincing as to the solvency of Lids. The Court reasoned HLHZ’s comparable transaction analysis, market multiple methodology and projections used to calculate value were insufficient and improperly relied upon. As a result, the Court found that Lids was insolvent at all relevant times and therefore the security interest was avoidable.



*In Re: Trans World Airlines, Incorporated*, 134 F.3d 188 (1998)

## THE PROPER INTERPRETATION OF THE DEFINITION OF INSOLVENCY

*In Re: Trans World Airlines, Inc., the Appellate Court found that when valuing a company on a "going concern" basis, the value of a company's assets should be determined using a fair valuation and the value of the debts should be valued using face value. The Appellate Court further found that when valuing assets of a corporation a reasonable period of time to convert non-cash assets into cash should be considered in the calculation.*

### Initial Transaction:

- Trans World Airlines, Inc. ("TWA") made a transfer in the amount of \$13.7 million to Travellers International AG ("Travellers"). Eighty-eight (88) days later TWA filed for bankruptcy and subsequently filed suit against Travellers, seeking a declaration that the \$13.7 million was a preferential transfer and voidable as a matter of law because TWA was insolvent at the time of the transfer.

### Background of the Court Case:

- The initial bankruptcy court determined that TWA was insolvent on the date of transfer and therefore the transfer was voidable. The bankruptcy court based its decision on the definition from Chapter 11 of the Bankruptcy Code, which states that a corporation is insolvent when "the sum of such entity's debts is greater than all of such entity's property, at a fair valuation" 11 U.S.C. § 101 (32)(A).
- However, the district court reversed the bankruptcy court's decision, stating it agreed with the valuation of the assets but disagreed on the value of the debts. The district court remanded the case with instructions to conduct a fair valuation of TWA's debts.
- The Appellate Court had to determine 1) How to properly measure the fair valuation of TWA's assets factoring in the period of time to convert non-cash assets to cash, and 2) Whether TWA's debt should be valued at face value or fair value.
- The Appellate Court held that a reasonable period of time to convert assets should be an estimate of the time that a creditor would find favorable, which is determined to be a short enough period of time to sell off the assets for the most money possible, but not in such a small period of time a company is receiving less satisfaction. The Appellate Court found that twelve to eighteen months was a sufficient period of time.



- The Appellate Court also held that TWA’s debt should be valued at face value rather than fair value. The Court determined that TWA should be treated as a “going concern” and therefore it should not consider the market’s devaluation of TWA’s debt which resulted from the possibility that TWA would cease operations as a result of the transfer. In sum, the Appellate Court held that TWA was insolvent on the date of transfer, concluding that TWA’s assets had a value of \$3.1 billion and its debts amounted to \$5.1 billion.



*Klang v. Smith's Food and Drug Centers, Inc.*, 702 A.2d 150 (Del 1997)

### **BOARDS OF DIRECTORS ARE ENTITLED TO RELY ON A SOLVENCY OPINION**

*In Klang v. Smith's Food and Drug Centers, Inc.*, a group of dissident shareholders alleged that a series of transactions, including a merger, leveraged recapitalization and stock repurchase rendered Smith's Food & Drug Centers, Inc. ("SFD") insolvent. The Court found that the Board of Directors ("Board") of SFD did not violate its fiduciary duty to its shareholders because it was entitled to rely on an independent solvency opinion.

#### **Initial Transaction:**

- The Board of Directors for SFD approved a series of transactions worth more than \$108 million, including: (a) a merger with The Yucaipa Companies ("Yucaipa"), (b) a leveraged recapitalization and (c) a stock repurchase.

#### **Background of the Court Case:**

- Prior to the closing of the transactions, SFD hired an investment advisory firm to render a solvency opinion and opine whether or not the transaction would endanger SFD's solvency.
- A group of dissident shareholders ("Plaintiffs") alleged that the transaction impaired SFD's capital and that the Board breached its fiduciary duties because the transaction rendered the company insolvent. The Plaintiffs further allege the Board was not entitled to rely on the solvency opinion because the methods underlying the solvency opinion were inappropriate as a matter of law since it failed to take into account all of SFD's assets and liabilities.
- The Court stated that it was satisfied with the solvency opinion rendered and adequately took into account all of SFD's assets and liabilities. The Plaintiff, therefore, had no reason to distrust the solvency opinion. Further the Court found that the Board appropriately selected an independent investment based on recommendations from SFD's legal counsel and financial advisor.
- The Court held the corporation's directors did not breach their fiduciary duty to the shareholders.



*In Re: Structurlite Plastics Corporation*, 193 B.R. 451 (Bankr. D. Ohio 1995)

**UNDERCAPITALIZED AND OVER-LEVERAGED TRANSACTIONS WITHOUT ADEQUATE CONSIDERATION CAN RESULT IN A FRAUDULENT CONVEYANCE**

*In Re Structurlite Plastics Corporation (“Structurlite”), the target, Structurlite, received little or no consideration for the obligations it undertook in connection with a leveraged buy-out (“LBO”) transaction. The buyers, GLL Corporation (“GLL”), infused little capital into the transaction, leaving Structurlite extremely leveraged. The Plaintiffs were able to prove a lack of fair consideration given to Structurlite in exchange for the loan made to GLL. As a result, the Court found that the various conveyances between GLL and the original stockholders were fraudulent as a matter of law and consequently void.*

**Initial Transaction:**

- GLL purchased Structurlite from the defendants, Robert Griffith and Charles Jones (“Owners”), via a LBO. GLL was formed specifically for the purpose of acquiring Structurlite. GLL contributed total capital of \$1,000 into the new corporation.
- Structurlite secured three loans from Bank One N.A. (“Bank One”). The first was a mortgage loan in the amount of \$1,000,000. The second was an equipment loan in the amount of \$500,000. The third was a revolver loan with a line of credit up to \$750,000. All of the loans were secured by assets of Structurlite. Subsequently, the proceeds from the mortgage loan were then lent to GLL, as an unsecured and unguaranteed loan.
- As consideration for the transaction, the Owners received a promissory note from GLL in the amount of \$3,000,000. GLL’s note to the Owners was secured by the assets and stock of Structurlite. Additionally, GLL made a cash payment of \$840,000 to the owners, which was financed from the \$1,000,000 mortgage loan.

**Background of the Court Case:**

- The Owners claimed that they neither knew the transaction was being financed through an LBO nor that the cash received was sourced from a loan between Structurlite and GLL.
- The Court ruled that the \$1,000,000 loan from Structurlite to GLL and the associated guarantee from GLL to the Owners were without consideration and hence fraudulent as a matter of law.
- The \$3,000,000 note from GLL to Owners was annulled. However, the Court could not recover the \$840,000 cash payment as a matter of law.



*In Re: Bay Plastics, Inc.*, 187 B.R. 315 (Bankr. C. D. Cal. 1995)

**SELLING SHAREHOLDERS COULD BE EXPOSED TO FRAUDULENT ATTACK IF THE LEVERAGED BUY-OUT WAS NOT A RESULT OF A LEGITIMATE TRANSACTION**

*In Re Bay Plastics Inc., the Court held that the proper application of fraudulent transfer law does not make the selling shareholders the guarantors of a successful leveraged buy-out (“LBO”) transaction. A LBO transaction that is leveraged beyond the net worth of the business is a gamble. The Court found that it is a risk that the new and old shareholders should be beholden to, because if the shareholders enjoy the benefits if the gamble pays off, they should also bear the burden if it does not.*

**Initial Transaction:**

- Milhous Corporation (“Milhous”) acquired Bay Plastics, Inc. (“Bay Plastics”) through a LBO transaction. BT Commercial Corp. (“BT”) provided financing for the transaction in the amount of \$3,950,000. Bay Plastics subsequently loaned this amount to Milhous, who, in turn, used the proceeds to cash out the selling shareholders of Bay Plastics. Milhous did not put any of its own money into the transaction. The loan from BT received first security in all of the assets of Bay Plastics.

**Background of the Court Case:**

- Three months prior to the LBO, Bay Plastics entered into a contract with Shintech, Inc. (“Shintech”) to supply Bay Plastics with PVC resin. In the terms of the original contract, Shintech had a security interest in all of Bay Plastics assets as well as personal guaranties from the shareholders.
- Prior to the closing of the LBO, the contract with Shintech was renegotiated and Shintech agreed to release both its security interest and guaranties. However, the terms and financing of the LBO transaction were not disclosed to Shintech.
- As a result of the highly-leveraged LBO, Bay Plastics was unable to service its debt levels and subsequently filed for bankruptcy. The trustee for Bay Plastics brought suit against the selling shareholders to avoid the payments made to the shareholders.
- The Court found that the transfer of money from Bay Plastics to Milhous to the selling shareholders constituted a single transaction, in which, the loan proceeds paid to the selling shareholders were secured by the assets of Bay Plastics. This transaction not only left the debtor insolvent, it also defrauded an existing creditor and therefore the Court concluded that the payment to the selling shareholders was avoidable.



*In Re: Miller & Rhoads, Inc.*, 146 B.R. 950 (Bankr. D. Va. 1992)

**THE STANDARD BY WHICH A COMPANY SHOULD BE VALUED ON A LIQUIDATION BASIS V. GOING CONCERN BASIS**

*In Re Miller & Rhoads, Inc. the Court found that when a business is in a precarious financial condition or on its deathbed, the assets should be valued on a liquidation basis rather than a going concern basis. When Miller & Rhoads Inc. (“M&R”) filed its bankruptcy petition, liquidation was imminent. Therefore, the Court concluded that M&R was on its deathbed and should be valued on a liquidation basis.*

**Initial Transaction:**

- In September of 1987, M&R Acquisition Corporation (“Buyer”) purchased M&R, a large retail department store, through a leveraged buy-out (“LBO”) for \$57,947,000. Buyer obtained its financing from General Electric Capital Corporation (“GECC”), securing the loan with the assets of M&R.

**Background of the Court Case:**

- Due to financial pressures M&R renegotiated terms with its creditors. However, M&R was still unable to make its payments and therefore on July 29, 1989, it filed for bankruptcy. The lower court granted M&R permission to receive new financing from GECC and, in turn, granted GECC superior priority status as a creditor. However the financing was not enough and M&R went into liquidation.
- The unsecured creditors then sought to obtain the right to bring preference claims for their benefit. In response to this, GECC, the primary secured creditor made an arrangement to contribute \$2,500,000 to the distribution fund for the unsecured creditors, in exchange for which GECC’s claim was assigned to M&R’s secured creditors trust.
- In September of 1990, GECC and the secured creditors’ trust sought to recover the preferential transfer to the unsecured creditors. The unsecured creditors claimed that M&R was solvent at the time of the transfers and therefore the transfers were legitimate.
- To determine M&R’s solvency the Court had to determine how to value M&R’s assets. The Court stated that fair valuation was generally defined as the going concern or fair market price unless a business is on its deathbed. However, when a business is in a precarious financial condition or on its deathbed, the assets should be valued on a liquidation rather than a going concern basis.
- The Court found that in order for M&R to continue as a going concern it required a minimum of a \$20,000,000 equity capital infusion, which was never likely and liquidation was imminent when the bankruptcy petition was filed. In sum, the Court concluded that M&R was on its deathbed and should be valued on a liquidation basis therefore declared insolvent at the time of the transfer.



*Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corporation, et al.*, 1991 Del Ch. Lexis 215

**THE IMPORTANCE OF DEAL TRANSPARENCY AND KNOWING THE FULL FINANCIAL STRUCTURE OF A TRANSACTION SO A LENDER CAN PROTECT ITS INVESTMENT**

*In Credit Lyonnais Bank Nederland v. Pathe Communications, had the lenders obtained an independent financial analysis opinions and performed proper due diligence, they may have been able to reveal the questionable dealings of the defendant and mitigated investment exposure.*

**Initial Transaction:**

- Defendant, Giancarlo Parretti (“Parretti”), through Defendant, Pathe Communications Company (“PCC”), performed a leveraged buy-out (“LBO”) of MGM/UA Communication Company (“MGM”). Credit Lyonnais Bank Nederland (“CLBN” or “Plaintiff”) financed the majority of the transaction with a loan to PCC in the amount of \$751,000,000.

**Background of the Court Case:**

- Directly after the November 1, 1990 closing of the transaction MGM found itself extremely short of cash and cash producing assets. In an attempt to alleviate the cash shortage, Parretti ordered the finance department to slow payments to its trade creditors and also proceeded to layoff key employees.
- CLBN’s parent, Banque Credit Lyonnais (“Credit Lyonnais”), noticing a significant outstanding balance owed from PCC and MGM, requested financial information from MGM’s auditors. Upon due diligence CLBN discovered poor financial management of PCC and MGM as well as certain financial dealings in conjunction with the LBO that were not made transparent to CLBN.
- At the same time, certain vendors of MGM filed bankruptcy proceedings against MGM due to payment defaults. In order to dismiss the charges, CLBN would have to finance MGM’s future cash flow deficit. CLBN stipulated it would finance MGM’s deficit so long as members of management would adhere to Corporate Governance Agreement (“CGA”), which included a Voting Trust Agreement (“VTA”) where Parretti’s voting rights of PCC and MGM shares were given to CLBN and held in an escrow account, to ensure that Parretti would adhere to the CGA.
- After continual attempts of Parretti to undermine the CGA and regain control of MGM, CLBN broke the escrow, assumed control of the voting rights and removed Parretti and his two selected members from the board.



- CLBN sought this action to enforce their rights as the rightful owners of the controlling stock in PCC and MGM.
- The Court found that by not making certain financial disclosures Parretti acted in bad faith and breached the CGA. Therefore, CLBN was legally entitled to exercise its rights under the VTA.



*Crowthers McCall Pattern, Inc. v. Lewis*, 129 B.R. 992 (SDNY 1991)

**LEVERAGED BUY-OUT (“LBO”) LENDERS ARE OBLIGATED TO REASONABLY DETERMINE THAT THE LBO DOES NOT VIOLATE THE COVENANTS OF OTHER CREDITORS**

*In Crowthers McCall Pattern, Inc. v. Lewis, the Court found that lenders have a duty to consider the post-transaction solvency of the target company and the rights of its post- transaction creditors when lending funds that flow out of the borrower to selling shareholders.*

**Initial Transaction:**

- John Crowther Group, plc (“Crowthers Group”) acquired TLC Pattern, Inc. (“TLC Pattern”) through the corporate entity, GJS One Acquisition, Inc. (“GJS One”), by means of a LBO.
- The purchase price was financed with a \$30.5 million equity investment from the Crowthers Group stockholders and a \$35.0 million bridge loan provided by Shearson Lehman Brothers Holdings Inc. (“Shearson”) and Bankers Trust Company (“Bankers Trust”) (collectively “Defendants”). After the transaction was completed, TLC Pattern became known as Crowthers McCall Pattern, Inc. (“Crowthers Pattern”).
- The proceeds of the bridge loan flowed directly to the selling shareholders. Soon after the transaction, the bridge loan was refinanced with permanent financing from Travelers Insurance Company and Travelers Indemnity Company (collectively, “Travelers”).

**Background of the Court Case:**

- A year after the completion of the LBO, Crowthers Pattern filed for bankruptcy. The Creditors’ Committee filed suit against the Defendants. The Creditors’ Committee alleged that the sale to GJS One was a fraudulent conveyance and Crowthers Pattern’s bankruptcy was a foreseeable result of the LBO.
- Shearson and Bankers Trust, (“Defendants”) argued that they could not be held liable for fraudulent conveyances because: (1) they merely made loans to GJS One, an intermediate entity and not Crowthers Pattern and (2) the loans were repaid.
- The Court however ruled that this was one integrated transaction where the funds flowed from the borrower directly to the selling shareholders and bypassed Crowthers Pattern therefore leaving it with \$35 million of debt, for which it received nothing in exchange.
- The Court further held that under fraudulent conveyance laws, a lender is required to make a reasonable determination that the transaction does not violate the covenants of post-transaction creditors.



*In Re: The O'Day Corporation*, 126 B.R. 370 (Bankr. D. Mass. 1991)

**UNSECURED CREDITORS WERE GIVEN PREFERENCE ABOVE THE PRIMARY CREDITOR BECAUSE THE PRIMARY CREDITOR SHOULD HAVE KNOWN THE TARGET WAS INSOLVENT**

*In Re the O'Day Corporation, the Trustee for the debtor, O'Day/Cal Sailboats Corp. ("O'Day") sought to set aside Meritor's security interest on the grounds that O'Day was insolvent and did not receive "fair consideration" at the time of the LBO transaction, therefore resulting in a fraudulent conveyance. The Court concluded that Meritor Savings Bank ("Meritor") knew O'Day was insolvent and the Court ruled that the mortgage, liens and security interests obtained by Meritor were void to the extent necessary to satisfy the unsecured creditors' claims.*

**Initial Transaction:**

- Lance T. Funston ("Funston") purchased O'Day and Prindle Boats Corporation ("Prindle") through a leveraged buy-out ("LBO") transaction for \$13,915,000. Funston had borrowed \$9,571,411 from Meritor, securing the loan by the assets of O'Day.

**Background of the Court Case:**

- Shortly after the completion of the LBO, an involuntary petition of bankruptcy was filed against O'Day by three of its creditors.
- Meritor filed a Motion for Relief under the Automatic Stay provision imposed by the Bankruptcy Code. Meritor asserted a security interest in all of O'Day's assets, as well as a mortgage lien on and security interest in the real property and improvements owned by O'Day.
- The Trustee for the creditors sought to avoid Meritor's security interest by claiming that the LBO was performed in an effort to hinder, delay or defraud creditors as the LBO rendered O'Day insolvent. The Trustee claimed that O'Day gave significant liens to Meritor, encumbering virtually all of its existing assets in exchange for nominal loan proceeds.
- Meritor argued even though O'Day utilized the proceeds to pay prior shareholders and Meritor was aware of the payment does not mean that O'Day did not receive Fair Consideration in exchange for the security interest granted.
- The Court concluded that O'Day was not provided with Fair Consideration and was rendered insolvent by the LBO. Therefore, the Court ruled that the liens and security interests obtained by Meritor on the date of closing were void to the extent necessary to satisfy the unsecured creditor's claims.

*Metropolitan Life Insurance Company v. RJR Nabisco Incorporated*, 906 F.2d 884 (1990)

**A SOLVENCY OPINION PROVIDES ASSURANCE TO PRIOR CREDITORS THAT THEY WILL CONTINUE TO RECEIVE PAYMENT**

*In the case of Metropolitan Life Insurance Company v. RJR Nabisco Incorporated, a proper solvency analysis would have mitigated litigation by providing assurance to creditors that RJR Nabisco would be able to continue to meet its payments and debt obligations.*

**Initial Transaction:**

- In December of 1988, RJR Nabisco (“RJR”) accepted a bid from Kohlberg Kravis Roberts & Company (“KKR”) for a \$25.0 billion leveraged buy-out (“LBO”) of the company. Shortly after the announcement of the LBO, RJR debt securities lost its “A” rating.

**Background of the Court Case:**

- As a result of the investment downgrade, Metropolitan Life Insurance Company (“MetLife”) and Jefferson-Pilot Insurance Company (“Jefferson-Pilot”) brought suit against RJR claiming that the LBO would seriously erode the value of their debt securities. MetLife and Jefferson-Pilot (collectively “Plaintiffs”) moved for a preliminary injunction prohibiting RJR from encumbering their assets unless RJR posted sufficient security to enable the Plaintiffs to redeem the debt securities.
- The bank loan agreements for the LBO required RJR to sell off certain of its assets, which were valued at \$5.5 billion and then use the proceeds to repay a portion of the LBO financing.
- While the parties’ motions were still pending, the Plaintiffs sent RJR six Notices of Default pursuant to the indenture agreements. The Notices claimed that the agreement, which stipulated the sale of RJR’s assets was equivalent to pledging RJR’s assets to the LBO lenders without equal and ratable security for the holders of the securities covered by the indentures. The sale, therefore, violated the negative pledge covenants.
- RJR moved for a preliminary injunction tolling the period during which it could cure the alleged defaults. The district court granted RJR’s motion.
- The Appellate Court, however, vacated the order tolling the cure periods. The Appellate Court held that the cure provisions in dispute were unambiguous and the district court acted in disregard of the unambiguous language of the indentures in tolling the cure period. Therefore, RJR was required to pay the debt security holders the amount due to them.
- A solvency opinion performed by an independent investment bank would have mitigated litigation by ascertaining the fiscal ability of RJR to meet its debt obligations as they came due prior to the transaction taking place.



*In The Matter of Taxman Clothing Co., Inc.*, 905 F. 2d 166 (7th Cir. 1990)

**IF A COMPANY IS NOT AT A POINT OF PERIL, THE PROPER STANDARD FOR VALUING ASSETS IS ON A GOING CONCERN BASIS**

*In the Matter of Taxman Clothing Co., Inc., the Seventh Circuit found that when a company has reached its point of peril its ability to continue as a going concern is uncertain because its expected costs are greater than its expected earnings. Since not all expected revenues and expected costs are capitalized, a balance sheet does not always yield an accurate picture of a firm's condition for a firm could be solvent in balance-sheet terms and yet be in danger of imminent failure. However, bankruptcy law has established a clear rule: balance-sheet solvency determines whether the payments to the creditors are voidable. In this case the Court determined Taxman Clothing Company's solvency by calculating what the clothing on hand could have been sold for, minus the costs of selling it, plus Taxman's other assets. Since the calculation exceeded the Taxman's liabilities, the Court concluded Taxman was solvent.*

**Initial Transaction:**

- Taxman Clothing Company, Inc. ("Taxman") made payments to its creditor, Arthur Winer ("Winer"), during the 90 days previous to filing for bankruptcy.

**Background of the Court Case:**

- The creditors appealed a lower court decision that ruled in favor of the bankruptcy trustee. The lower court found that Taxman was insolvent on the date of the transfers and therefore the transfers were void.
- On appeal, the Seventh Circuit had to make a determination of solvency based upon the value of the clothing inventory that Taxman had in the store at the time of the transfers as Taxman had few other assets and liabilities.
- At the bankruptcy trustee's auction sale the clothing inventory of Taxman was sold for \$110,000. The bankruptcy trustee used this value as evidence of its insolvency. However, the creditors argued the fair value of the clothing was \$215,000, which was the going concern value that the successful bidder had appraised the clothing, prior to the auction.
- The Seventh Circuit ruled in favor of the creditors and determined that since Taxman was not at a point of peril, the clothing inventory should be valued as a going concern and therefore Taxman was solvent at the time of the transfers.



*Wieboldt Stores Inc. v. Schottenstein, et al.*, 94 B.R. 488 (N.D. Ill 1988)

**IF A LEVERAGED BUY-OUT LEAVES A COMPANY INSOLVENT AND IT WAS DONE IN AN ATTEMPT TO DECEIVE CREDITORS, A FRAUDULENT CONVEYANCE CAN BE FOUND AS WELL AS A BREACH OF FIDUCIARY DUTY**

*In Wieboldt v. Schottenstein, the plaintiff, Trustee for Wieboldt, and its unsecured creditors sought to invalidate the tendered offer and leveraged buy-out (“LBO”) transaction as a fraudulent conveyance. This case identifies a fundamental underpinning of a LBO transaction: the sum of the target company’s debts shall not exceed the sum of its assets “at a fair valuation,” otherwise the company will be declared insolvent and the transaction will be deemed a fraudulent conveyance. As this case demonstrates, the purchaser and the lenders to a LBO should prevent any appearance of lack of good-faith by obtaining an independent, third party to provide a solvency opinion.*

**Initial Transaction:**

- WSI Acquisition Corp. (“WSI”) acquired Wieboldt Stores, Inc. (“Weiboldt”), a large retail chain in the Chicago area, through a LBO for \$38,462,164. Household Commercial Finance Services (“HCFS”) financed the entire purchase price using the assets of Weiboldt to secure the loan. WSI used the proceeds of the loan to buy-out the shareholders shares.

**Background of the Court Case**

- During the negotiations for the acquisition, Wieboldt’s Board of Directors learned that HCFS would provide financing for the deal only if Wieboldt obtained an independent third party solvency opinion. The Board informed HCFS that it would continue only if this requirement was dropped and HCFS consented and agreed to finance the transaction.
- The LBO reduced the assets available to Wieboldt’s creditors. Wieboldt contends that, after the buyout was completed, Wieboldt’s debt level had increased by millions of dollars leaving it insolvent. Weiboldt’s further asserts that the LBO transaction was not for the benefit of the corporation because the proceeds made available by the LBO were paid out directly to the former shareholders and not to the corporation.
- Trustees for Wieboldt’s sought to invalidate the LBO as a fraudulent conveyance and asserted state claims for breach of the directors’ fiduciary duty and improper shareholder distributions.
- The Court stated that the Motion to Dismiss raised by the LBO lenders, insider shareholders and controlling shareholders was denied. At the time of the transaction, Weiboldt’s debt exceeded the sum of its assets. As a result, the Court found that this was a fraudulent transfer and therefore void.



*In The Matter of Ohio Corrugating Co.*, 70 B.R. 920 (Bankr. N.D. Ohio 1987)

**A MONEY JUDGMENT MAY BE HAD AGAINST ANY ENTITY THAT BENEFITS FROM FRAUDULENTLY CONVEYED PROPERTY**

*In The Matter of Ohio Corrugating Co.*, it was decided that a money judgment may be awarded not only against the transferee of fraudulently conveyed property but also against any entity for whose benefit the transfer was made. The Court stated that the solvency of a company is determined on a case by case basis and that once the plaintiff shows the transfer in question lacked fair consideration, the burden of proof shifts to the debtor to prove his solvency on the date of the transfer and afterward.

**Initial Transaction:**

- DPAC Inc. (“DPAC I”) through the vehicle of a leveraged buy-out (LBO) transaction purchased all of the outstanding stock of Ohio Corrugating Co. (“Ohio Corrugating”). To finance this transaction DPAC I obtained a loan in the amount of \$1,475,000 from Security Pacific Business Credit Inc. (“Security Pacific”), which was secured by the assets of Ohio Corrugating.
- Another holding corporation, Geromac (“Geromac”), was formed to purchase all the stock from DPAC I. Subsequent to the transaction, DPAC I ceased to exist and Geromac changed its name to DPAC II and became the sole shareholder of Ohio Corrugating, thereby assuming the loan with Security Pacific.

**Background of the Court Case:**

- Subsequent to the formation of DPAC II, Ohio Corrugating filed for bankruptcy. The Creditors’ Committee filed a complaint against Security Pacific, DPAC II, and Malcolm Sheppard (“Sheppard”), the majority shareholder of DPAC II. The only defendants having motions on appeal were DPAC II and Sheppard.
- DPAC II argued that the complaint failed to allege a cause of action since the company was not in existence prior to the closing and, therefore, not a party to the transaction. Sheppard argued the plaintiffs had no cause of action against him since the complaint did not claim that he acted independent of Ohio Corrugating.
- The Court ruled the complaint did state a cause of action against the defendants as DPAC II and Sheppard were considered as entities for whose benefit the LBO transaction was made.



*United States of America v. Tabor Realty Corp., et al.*, 803 F.2d 1288 (3rd Cir. 1986)

**FRAUDULENT CONVEYANCE LAW CAN BE APPLIED TO A LEVERAGED BUY-OUT IF IT IS FOUND THAT THE LENDERS DID NOT ACT IN GOOD FAITH**

*In U.S. v. Tabor Realty Corp., the Court established that parties participating in a leveraged buy-out transaction did not act in good faith by attempting to deceive their creditors. As a result, the Court declared the transactions void.*

**Initial Transaction:**

- Raymond Colliery Co., Inc., (“Raymond Group”) one of the largest anthracite coal producers in the United States was sold for \$7,200,000 to a holding company, Great American Inc. (“Great American”), in a leveraged buy-out (“LBO”) transaction financed by Institutional Investor Trust (“IIT”). Great American’s loan from IIT was in the amount of \$8,530,000.

**Background of the Court Case:**

- Prior to the transaction, Raymond Group had acquired substantial amounts of debt, including multi-million dollar liabilities for federal income taxes, trade accounts, pension fund contributions, strip mining and back-filling obligations and municipal real estate taxes. Within two months of closing the LBO transaction, Raymond Group was unable to fulfill its prior contractual obligations and consequently was rendered insolvent by the LBO.
- Upon insolvency, Lackawanna and Luzerne counties announced their intent to sell off the properties which Raymond Group owed back municipal taxes. McClellan Realty (“McClellan”) and Tabor Court Realty (“Tabor”) which were established by Pagnotti Enterprises (“Pagnotti”), another large anthracite producer, solely to purchase the properties that were to be auctioned off by the counties. Pagnotti purchased the IIT mortgages in the amount of \$4,500,000, assuming a portion of the back taxes and subsequently transferred the mortgages to McClellan.
- The U.S. government commenced an action to reduce to judgment certain federal corporate tax assessments made against the companies involved in the LBO transaction.
- The U.S. government contended the mortgages, which were part of the transaction, should be set aside under the Uniform Fraudulent Conveyance Act and that further assignment of these mortgages to McClellan Realty should be declared void because McClellan knew that the mortgages were conveyed in an attempt to hinder the primary creditor, the U.S. Government.



- The court found that defendants did not act in good faith and that fraudulent conveyance law was properly applied to the LBO. The Court entered an order declaring the assigned mortgages and other security instruments of McClellan to be void.



## Glossary:

**Actual Fraudulent Conveyance:** Actual intent to hinder, delay or defraud any creditor.<sup>97</sup>

**Badges of Fraud:** Factors used to guide courts in determining whether debtor transferred property with specific intent to hinder, delay, or defraud creditors.<sup>98</sup>

**Balance Sheet Test:** Requires the court to determine what value to attribute to the prospective and contingent liabilities of a company. The court must compare present assets with present and future liabilities and, making allowance for contingencies and deferred payments, assess whether the company can be reasonably expected to meet all of its liabilities.<sup>99</sup>

**Cash Flow Test:** Whether the corporation has been paying bills on a timely basis and/or whether its liabilities exceed its assets.<sup>100</sup>

**Constructive Fraudulent Conveyance:** If a transfer was not made for fair consideration, then, depending upon financial condition of transferor at or immediately after time of transfer, the transfer may be fraudulent.<sup>101</sup>

**Going Concern Value:** The value of a company as an ongoing entity. This value differs from the value of a liquidated company's assets, because an ongoing operation has the ability to continue to earn a profit, while a liquidated company does not.<sup>102</sup>

**Leveraged Buyout:** Acquisition of another company using a significant amount of borrowed money to meet the cost of acquisition.<sup>103</sup>

**Trustee:** Person that holds and administers property or assets for the benefit of a third party.<sup>104</sup>

**Unreasonably Small Capital:** An "unreasonably small capital" would refer to the inability to generate sufficient profits to sustain operations. Because an inability to generate enough cash flow to sustain operations must precede an inability to pay obligations as they become due, unreasonably small capital would seem to encompass financial difficulties short of equitable solvency.<sup>105</sup>

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<sup>97</sup> 12 Pa.C.S.A. § 5104

<sup>98</sup> 740 ILCS 160/5

<sup>99</sup> <https://www.lexology.com/library/detail.aspx?g=86db1422-4c16-47c1-b47e-fd31ec35d67f>

<sup>100</sup> *Pereira v. Farace*, 413 F.3d 330, 343 (2d Cir. 2005).

<sup>101</sup> 12 Pa.C.S.A. § 5104

<sup>102</sup> [http://www.investopedia.com/terms/g/going\\_concern\\_value.asp?ad=dirN&qo=investopediaSiteSearch&qsrc=0&o=40186](http://www.investopedia.com/terms/g/going_concern_value.asp?ad=dirN&qo=investopediaSiteSearch&qsrc=0&o=40186)

<sup>103</sup> <http://www.investopedia.com/terms/l/leveragedbuyout.asp?ad=dirN&qo=serpSearchTopBox&qsrc=1&o=40186>

<sup>104</sup> <http://www.investopedia.com/terms/t/trustee.asp?ad=dirN&qo=serpSearchTopBox&qsrc=1&o=40186>

<sup>105</sup> *Moody v. Security Pacific Business Credit, Inc.*, 971 F.2d 1056 (3d Cir. 1992).