

7th Circuit Says Fraudulent Transfer Laws Apply to LBOs

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In a recent decision authored by Judge Richard Posner, the 7th Circuit U.S. Court of Appeals addressed the application of fraudulent transfer laws to leveraged buy-out transactions (LBOs). The court's ruling in *Boyer v. Crown Stock Distribution, Inc., et al.*, 587 F.3d 787 (7th Cir. Nov. 21, 2009) is especially noteworthy because it addressed — and rejected — several defenses commonly asserted when failed LBOs are challenged in bankruptcy cases.

Crown Unlimited Machine, Inc., (Old Crown) designed and manufactured custom machinery for cutting and bending tubes. Old Crown was privately owned and managed by the Stroup family. In January 1999, Old Crown's shareholders agreed to sell all of the company's assets to an entity (New Crown) formed by one Kevin E. Smith.

Upon the transaction's closing in January 2000, Old Crown received \$3.1 million in cash, which was distributed to its shareholders, and a promissory note in the amount of \$2.9 million. New Crown borrowed the entire purchase price from a bank, which was granted a first-priority security interest on New Crown's assets. Smith contributed only \$500 to the new enterprise. Old Crown was granted a second-priority lien on the assets of New Crown under the promissory note, which was payable on April 1, 2006.

In addition, Old Crown transferred about \$590,000 from its corporate bank account into a separate account just prior to the closing so that the money could be distributed to

Old Crown's shareholders as a dividend rather than be transferred to New Crown as part of the transaction.

New Crown Bankruptcy

After the transaction closed, New Crown possessed little or no working capital other than what it could borrow from the bank or generate from its ongoing business. Not surprisingly, New Crown struggled to continue operations while servicing its debt to the bank and Old Crown. By January 2003, New Crown had incurred debt totaling \$8.3 million, even though its assets were worth less than half that amount.

In the court's words, New Crown was on "life support" immediately after the transaction was consummated and was doomed to fail as a result of its lack of working capital and leveraged capital structure.

In July 2003, roughly 3½ years after the transaction closed, New Crown filed a petition under Chapter 7 of the Bankruptcy Code. New Crown's assets were ultimately sold in a Section 363 sale to a new company (of which Smith was president) for \$3.7 million. Most of the sale proceeds were used to pay the bank, leaving little left over for distribution to unsecured creditors.

Tasked with maximizing returns for New Crown's unsecured creditors, the Chapter 7

trustee commenced an adversary proceeding under the Indiana Fraudulent Transfer Act, made applicable by Section 544 of the Bankruptcy Code, and Section 550 of the Bankruptcy Code to (i) recover the \$3.1 million paid to the shareholders of Old Crown by New Crown, (ii) avoid New Crown's liabilities to Old Crown under the promissory note, and (iii) recover the dividend paid to Old Crown's shareholders on the eve of the transaction.

The Bankruptcy Court found that the consideration that New Crown paid for the assets of Old Crown (*i.e.*, the \$3.1 million in cash and the \$2.9 million promissory note) was made without New Crown receiving reasonably equivalent value in exchange and caused the new company to possess an unreasonably small amount of capital in relation to its business.

In the court's words, New Crown was on "life support" immediately after the transaction was consummated and was doomed to fail as a result of its lack of working capital and leveraged capital structure. Accordingly, the Bankruptcy Court deemed those aspects of the transaction to be fraudulent transfers.

Nonetheless, the court ruled that the dividend could not be recovered by the trustee because it had been paid out of the cash of Old Crown and not from the property of New Crown. In so ruling, the court rejected the trustee's arguments that (i) the purchase of

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Old Crown's assets was an LBO, (ii) the transaction should be "collapsed," and (iii) the sale of Old Crown's assets should be recharacterized as a sale by its shareholders of their interests in the company so that the dividend should be viewed as an asset of the estate that could be recovered by the trustee for the benefit of New Crown's unsecured creditors

The U.S. District Court affirmed, and both sides appealed, with the trustee seeking to overturn the court's ruling as to whether the dividend was part of the transaction and the shareholders challenging the court's findings that the transfer of the assets from Old Crown to New Crown was a fraudulent transaction.

7th Circuit's Response

The 7th Circuit U.S. Court of Appeals began its analysis by considering whether, as the trustee argued, the entire transaction (including the payment of the dividend) was, in fact, an LBO that should be collapsed.

After acknowledging that some courts have been reluctant to apply fraudulent transfer laws to LBO transactions, Judge Posner observed that this reticence "is not easy to square with the language of the Uniform Fraudulent Transfer Act," which applies to any transfer of assets pursuant to which the transferor does not receive reasonably equivalent value and that leaves the transferor (i) insolvent, (ii) with an unreasonably small amount of capital; or (iii) unable to pay its debts as they become due. *Boyer*, 587 F.3d at 792.

Regardless, the court observed that "whether one calls it an LBO or not is not critical....Some LBOs are legitimate, and others are fraudulent conveyances." *Id.* The court observed that "fraudulent conveyance doctrine...is a flexible principle that looks to substance, rather than form, and protects creditors from any transactions the debtor engages in that have the effect of impairing their rights, while ensuring that the debtor can continue to do business and assuring third parties that transactions done at arms-length will not be second-guessed." *Id.* (citing Douglas G. Baird, *Elements of Bankruptcy*, 153-4 (4th ed. 2006)) (emphasis added). The court stated that "if one has to call the overall transaction something, the something is an LBO." *Id.*

In so ruling, the court rejected the two main arguments of the shareholders. First, the shareholders had argued that the transaction was not

an LBO because New Crown bought the assets of Old Crown, rather than its stock. The court rejected this distinction as insignificant, noting that, in substance, the transaction transferred *ownership* of the company to New Crown. The court pointed out that (i) Old Crown distributed all of the consideration it received to its shareholders and, post-transaction, existed only as a shell; (ii) New Crown operated under the same name as Old Crown; and (iii) the company's trade creditors and other unsecured creditors were not even informed about the transaction.

Second, the shareholders argued that the payments made to them, including the dividend, were not fraudulent because New Crown was able to stave off bankruptcy for several years after the transaction closed and could have operated even longer if not for business mistakes made by Smith. The court concluded that the Bankruptcy Court's ruling relating to the cash consideration paid to Old Crown and the inurrence of debt under the promissory note was not clear error.

Even if New Crown was not actually insolvent as a result of the transaction, the court said, the fact it was forced to engage in continual borrowing to continue operations demonstrated that it was inadequately capitalized from the time of the transaction through its bankruptcy, regardless of when the filing occurred. The court stated that whether a transfer is fraudulent depends on the conditions that existed when it was made, not on what happened after the transfer to affect the timing of the company's bankruptcy, such as the business decisions of its officers. *Id.* at 795.

In addition, the court overruled the Bankruptcy Court with respect to the dividend, characterizing it as an integral part of the LBO. The court observed that while family-owned companies like Old Crown rarely pay dividends, instead choosing to channel profits into salary to avoid double taxation, the dividend represented 50 percent of Old Crown's 1999 profits, which was unreasonably high given the post-LBO cash needs of the business. Based on these indications, the court concluded that the dividend was part of a fraudulent transfer and not an ordinary course distribution of company profits, as argued by the shareholders.

Noteworthy Decision

The court's ruling in *Boyer* is noteworthy for several reasons. First, the court refused to adopt

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the reasoning of cases that have expressed reservations about applying fraudulent transfer laws to LBOs, such as *Kupetz v. Wolf*, 845 F.2d 842 (9th Cir. 1988), notwithstanding that many have argued that LBOs are beneficial transactions that facilitate changes in corporate control and increase the efficient use of capital.

Indeed, while Posner specifically noted that LBOs “may have redeeming economic value when the corporation is publicly held,” such a rationale was not present in the case at bar because both corporations were closely held. *Id.* at 793. Even though the court explicitly noted that the LBO in *Boyer* differed from a conventional LBO in that the transaction at issue “was highly likely to plunge the company into bankruptcy,” such a ruling from one of the leading proponents of the law and economics theory carries significant weight.

Second, the court's analysis of the length of time between the LBO and the bankruptcy may pose a problem for defendants in future fraudulent transfer actions. Indeed, the length of the interval between an LBO and a bankruptcy is often cited by defendants in fraudulent transfer cases as evidence that a company was not inadequately capitalized after a transaction. Further, some courts have ruled that the passage of as little as 10 or 12 months is sufficient to create the presumption that an LBO was not the proximate cause of a company's bankruptcy. See *e.g.*, *Moody v. Security Pac. Bus. Credit, Inc.*, 971 F.2d 1056, 1073-74 (3d Cir. 1992); *MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Servs. Co.*, 910 F. Supp. 913, 944 (S.D.N.Y. 1995); *In re Joy Recovery Technology Corp.*, 286 B.R. 54, 76 (Bankr. N.D. Ill. 2002).

The *Boyer* court expressed skepticism with these cases because of a company's ability to “stagger along for quite some time, concealing a parlous state or persuading creditors to avoid forcing it into a bankruptcy proceeding in which perhaps only the lawyers do well.” *Id.* at 795. Although a company may be insolvent on a balance sheet basis, it may nevertheless continue operating as long as it was able to raise money to pay its debts as they became due — or even longer, as long as creditors are willing to forbear on exercising their rights in the face of a company's defaults.

While the court noted that the 3½ years between the LBO and New Crown's bankruptcy was a longer interval than those in previous cases, it affirmed the lower court's ruling that the transaction was fraudulent in light of the fact

that shareholders were “unable to sketch a plausible narrative in which new Crown could have survived indefinitely despite being cash starved as a result of the terms of the LBO that brought it into being.” *Id.*

It is unlikely that the court intended to announce a new stringent burden of proof for defendants in fraudulent transfer actions that seek to invoke the length of time between an LBO and a bankruptcy as evidence that the post-transaction was adequately capitalized. However, the court's analysis serves as a thoughtful and practical counterbalance to decisions that can be interpreted as holding that an LBO cannot be a fraudulent transfer so long as the leveraged company survives for some definite period of time. [CR](#)

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THE JOURNAL OF CORPORATE RENEWAL