Claims Based on Insolvency in the Wake of The Coronavirus Pandemic

Executive Summary

The coronavirus disease (COVID-19) arrived at a time when share buybacks and dividends were at historic highs (and indenture covenants notoriously light). But the pandemic may already have significantly reshaped the landscape for many companies that recently made payments to shareholders in the form of share buybacks, leveraged buyouts, or dividends, or were planning to take these actions before the pandemic began. Given the challenging financial outlook many of these companies now face, such transactions are likely to come under increasing scrutiny by creditors, who may look to utilize fraudulent transfer and other laws to determine whether money distributed by companies to buy shares or pay dividends can be recovered for the benefit of creditors, and whether companies can avoid their obligations to pay competing debt raised to fund such distributions. This article discusses the key issues that creditors, companies and their sponsors, and lenders should consider when assessing distributions to shareholders that may be contemplated going forward, and those that have already been completed.

I. Laws Relating to a Company's Insolvency and Restricting Payments To Shareholders

Laws enabling a creditor to avoid a transfer of property by an insolvent debtor have existed since the 17th century, and enacted as statutes in every state for well over a hundred years. Transfers to a debtor's shareholders have long been the targets of such claims, both in and out of bankruptcy proceedings.

The Bankruptcy Code includes constructive fraudulent transfer statutes providing that if a company makes a transfer or incurs an obligation for less than "reasonably equivalent value" at a time when it is insolvent, inadequately capitalized, or unable to meet its debts as they come due, or will be rendered as such as a result of the transfer or obligation, then the transfer or obligation may be avoided and, in the case of transfers, recovered for the benefit of the company's creditors. The Bankruptcy Code also provides for the avoidance of certain kinds of transfers to insiders, and the avoidance of transfers and obligations as intentional fraudulent transfers if they are made with the intent to hinder, delay, or defraud creditors.

Each state has similar fraudulent transfer statutes that may be invoked by creditors in the absence of a bankruptcy filing, and some states have also passed laws imposing personal liability on directors who willfully or negligently authorize the issuance of a dividend or redemption of stock if the corporation has insufficient capital.

Fraudulent Transfer

It is generally settled that a company that pays dividends to its shareholders, or redeems its stock in connection with a share buyback or leveraged buyout, does not receive "reasonably equivalent value," as that term is used in the state and federal constructive fraudulent transfer statutes. Further, in some circumstances, payments to insiders, such as on account of loans or management fees, can also be avoided as constructive fraudulent transfers even if made for reasonably equivalent value, if the debtor was insolvent at the time that the transfer was made. For intentional fraudulent transfer claims, the question is whether a debtor made a transfer with the intent to hinder, delay or defraud creditors, and the analysis almost always requires a showing that the debtor was insolvent at the time of, or rendered insolvent by, the transfer.

Thus, a challenge to any such transfer as a constructive fraudulent transfer will hinge on the financial condition of the company at the time of the transfer. The analysis employed by courts when determining whether a company is insolvent, has unreasonably small capital, or is unable to pay its debts as they mature is summarized below:

- ***Balance Sheet Insolvency.*** A company is "balance sheet insolvent" if the fair value of its liabilities exceeds the fair value of its assets. *See, e.g.*, *Mellon Bank, N.A. v. Metro Commc'ns, Inc.*, 945 F.2d 635, 648 (3d Cir. 1991); *In re Lyondell Chem. Co.*, 567 B.R. 55, 109 (Bankr. S.D.N.Y. 2017). Notwithstanding the accounting-centric title of the test, it does not utilize the "book value" of assets. Rather, as one appellate court explained, the primary question is: "What would a buyer be willing to pay for the debtor's entire package of assets and liabilities? If the price is positive, the firm is solvent; if negative, insolvent." *Covey v. Commercial Nat. Bank of Peoria*, 960 F.2d 657, 660 (7th Cir. 1992). Courts will look to various methodologies to test a company's balance sheet solvency, including discounted cash flow, comparables companies/transactions, and contemporaneous market evidence. Although courts look to market evidence (like trading prices) as a measure of solvency, there is always the question of how efficient the markets are and thus how much weight to put on that evidence. Given the market turmoil in connection with the COVID-19 pandemic, there may be colorable arguments militating against placing too much weight on market prices.

- ***Unreasonably Small Capital.*** "Unreasonably small capital" is a financial condition that may fall short of balance sheet insolvency but will likely lead to insolvency at some point in the future. "The difference between insolvency and 'unreasonably small' assets … is the difference between being bankrupt on the day" the transaction is consummated and "having at that moment such meager assets that bankruptcy is a consequence both likely and foreseeable." *Boyer v. Crown Stock Distribution, Inc.*, 587 F.3d 787, 794 (7th Cir. 2009); *see also In re Lyondell Chem. Co.*, 567 B.R. at 109. Courts consider a number of factors to determine whether a company has reasonable capital at the time of a transfer or incurrence of an obligation, including financial metrics relative to industry peers, foreseeable future events impacting performance, and the availability of additional borrowing.

- ***Inability to Pay Debts As They Mature.*** A transfer or obligation will also be avoided where the company intended to incur, or believed that it would incur, debts that would be beyond its ability to pay as they matured. While the statute suggests a standard based on subjective intent, courts have held that the intent requirement can be inferred where facts and circumstances surrounding the transaction show that the company could not have reasonably believed that it would be able to pay its debts as they matured.

Illegal Dividend

Some states also have statutes making it illegal for corporations to issue dividends or redeem stock when they are in financial distress. For example, under section 173 of the Delaware General Corporations Law ("DGCL"), a dividend is illegal unless it is made out of "surplus" or, if no surplus exists, out of net profits for the fiscal year in which the dividend is declared or the preceding year. *See also* 6 DGCL § 18-607 (imposing liability on LLC members that knowingly received unlawful distributions). And a share redemption is illegal under DGCL section 160 if it is made "when the capital of the corporation is impaired, or when such purchase or redemption would cause any impairment of the capital of the corporation." "Surplus" is the amount by which total assets exceed total liabilities, and thus is similar to balance sheet insolvency, and capital is generally "impaired" when the funds used for a redemption exceed surplus. Under DGCL section 174, directors who willfully or negligently approve an illegal dividend or share redemption are "jointly and severally liable" for the full amount of the wrongfully-approved transfer. New York law contains similar provisions.

II. Relevant Considerations For Creditors, Companies And Their Sponsors, And Lenders

The uncertain economic outlook caused by COVID-19 will undoubtedly result in intense scrutiny over dividends to shareholders, stock buybacks, and redemptions that were recently completed and that may be consummated going forward. Creditors, companies and their sponsors, and lenders alike should be cognizant of the risks that such transactions will be challenged as fraudulent transfers or illegal dividends, the steps that can be taken to seek the avoidance and disgorgement of moneys paid to shareholders, and measures that may be implemented to protect such payments from challenge.

Creditors

Creditors of companies that are no longer able to pay their debts, and that redeemed their stock or issued dividends in the early months of 2020, may look to challenge the transfers made to shareholders (and any obligations incurred to fund such payments) as actual or constructive fraudulent transfers or illegal dividends on the ground that the company should have foreseen the economic downturn that was to come, and/or was able to predict the downturn but issued the dividend or redemption anyway in an effort to transfer value to shareholders while it still could. An analysis of balance sheet solvency "should begin with a review of management's projections," which the court will assess for reasonableness based on what was known at the time of the transfer or incurrence of obligation. *In re Lyondell Chem. Co.*, 567 B.R. at 109-110; *In re Iridium Operating LLC*, 373 B.R. 283, 347 (Bankr. S.D.N.Y. 2007). Similarly, the test for unreasonably small capital and inability to pay debts is "reasonable foreseeability." *Moody v. Security Pacific Business Credit, Inc.*, 971 F.2d 1056 (3d Cir. 1992). While it may be unlikely that a company could have foreseen the unprecedented COVID-19 outbreak and the economic downturn it has caused, creditors may argue that COVID-19's impact became reasonably foreseeable in the weeks or months before it was labeled a pandemic, or reached American shores. Creditors may also argue that a company was already insolvent prior to COVID-19, and that the virus was only an overlapping, intervening cause. The flip side of this, is that defendants in a fraudulent transfer case are likely to argue that COVID-19 caused the company's insolvency or inadequacy of capital, even where there is strong evidence that the company was already at that point prior to the pandemic. This may lead to significant factual and expert-driven disputes regarding the company's financial condition, perhaps more than typical. Additionally, creditors of companies that choose to go forward with redemptions or dividends in the current economic climate, and subsequently suffer financial distress, will undoubtedly challenge the payments to shareholders and any associated debt incurred by the company.

If the company in question files for federal bankruptcy protection, creditors' rights to pursue claims for fraudulent transfer or illegal dividend will vest in the bankruptcy estate, to be pursued for the benefit of all of the debtor's creditors by the bankruptcy trustee (or debtor in possession in chapter 11 cases), or, under certain circumstances, by other parties, such as a creditors' committee, standing in the debtor's shoes. Unlike state law fraudulent transfer statutes, bankruptcy law permits the bankruptcy estate to avoid a transfer for the benefit of all creditors, even if certain creditors would not otherwise be able to bring fraudulent transfer claims on their own. Depending upon the nature and structure of the payments to shareholders, the shareholders may be immunized from constructive fraudulent transfer claims under the Bankruptcy Code's "safe harbors," but will still be subject to claims for intentional fraudulent transfers made during the two-year period preceding the bankruptcy filing. Creditors should monitor the bankruptcy case closely, and may want to take an active role in the proceedings to ensure that claims relating to payments to shareholders are being effectively pursued.

But creditors do not need a bankruptcy filing in order to pursue fraudulent transfer claims. Rather, in the absence of such a filing, creditors themselves may challenge payments to shareholders and associated debt obligations under state law fraudulent transfer and illegal dividend statutes. While the Bankruptcy Code safe harbors will not apply outside of bankruptcy, however, creditors could face other limitations. For instance, although fraudulent transfer claims are not rooted in contract, bond indentures routinely include "no action" clauses that may restrict an individual bondholder's ability to commence a lawsuit. The no action clauses typically limit bondholders' right to institute an action either (i) solely with respect to the indenture, or (ii) with respect to the indenture or the notes. Where the indenture includes the former language, the no-action clause will not limit a creditor's rights to assert its own fraudulent transfer claims if the indenture is governed by New York law. *Quadrant Structured v. Vertin*, 23 N.Y.3d 549 (2014). However, where an indenture's no-action clause extends to claims under the "Notes" or "Securities" (in addition to merely claims under "the Indenture"), creditors will have to confront the no-action clause in order to pursue the claims directly.

To date, it has been generally accepted that the indenture trustee appointed under an indenture may act where the no action clause prevents bondholders from doing so. However, the defendant in *UMB Bank, N.A. v. Neiman Marcus Group, Inc.*, Index. No. 654509/2019 (N.Y. Sup.) is currently asserting that an indenture trustee may not assert a fraudulent transfer claim if there is no contractual default under the indenture, even where the bondholders may be precluded from doing so by the no action clause. The Delaware Chancery Court recently held that Delaware law does not require a plaintiff-creditor to hold an accelerated or mature claim before commencing suit, but it remains to be seen whether an indenture trustee (which is inherently subject to the terms of its indenture) may do so, and if not, whether bondholders subject to an indenture with the broader no action clause may. *Burkhart v. Genworth Financial, Inc.*, No. 2018-0691-JRS (Del. Ch. Jan. 31, 2020) ("[A] creditor with an unmature and contingent claim does have standing to bring a claim under [Delaware's Uniform Fraudulent Transfer Act] even though her contractual right to payment is contingent and not yet mature."). The law on this issue continues to evolve, and creditors seeking to challenge payments to shareholders or other transfers in the absence of a bankruptcy should ensure that they have considered this issue from all angles before commencing suit.

Companies And Their Sponsors

As may go without saying, companies and sponsors that are currently planning share redemptions or dividends should look closely at the company's financial condition, and move forward only where they can comfortably conclude that the company has sufficient value and adequate liquidity to continue as a going concern following the transaction, taking into consideration reasonable assumptions regarding future performance and the impact of COVID-19 (as the virus is understood at the time of the transfer). Retaining an outside advisor to issue a solvency opinion is also a prudent course, though the opinion itself may be subject to challenge, and is not a guarantee that the payment will not be avoided.

Lenders

Finally, lenders that are asked to knowingly fund distributions to shareholders should also be aware that the company's creditors, or in the case of a bankruptcy, an estate representative acting on their behalf, may subsequently seek to avoid the debt, as well as recover any interest or principal payments that have been made. While lien transfers made and obligations incurred on account of loans that ostensibly provided actual proceeds to the borrower are typically considered to be for reasonably equivalent value, under a theory referred to as "collapsing," *HBE Leasing Corp. v. Frank*, 48 F.3d 623 (2d Cir. 1995), a court may treat the lenders as providing no value to the company if they were aware that the proceeds of their loan would be used to fund a second transfer that would provide no value to the company, such as a dividend or stock redemption.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to reach out to:

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