Elizabethan England
to the 2010 global recession

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As the US and world markets continue to struggle, businesses have continued to fail and asset values across the board have generally fallen substantially. These circumstances are acerbated by credit markets that have yet to normalise. Lenders are increasingly facing collateral liquidation values insufficient to cover the obligations owed. Moreover "going concern" collateral valuations aren't much better, discouraging lenders from funding chapter 11 proceedings to achieve a successful reorganisation or liquidation plan. If anything, lenders are willing to fund only a "bare-bones" chapter 11 budget to achieve a quick sale liquidation, usually only the transaction costs directly associated with a Section 363 sale. There is little appetite to fund other administrative claims (such as costs associated with an active creditors' committee or administrative claims for recently delivered goods), much less any dividend for unsecured creditors. Yet in many chapter 11 cases, committees of unsecured creditors continue to be formed and are active, as advocates for the interests of unsecured creditors. There is an inherent tension between the lenders, who are attempting to minimise its loss, and unsecured creditors, who are attempting to recover payment for goods and services provided to the debtor.

Given these circumstances, creditors (or chapter 11 debtors on behalf of creditors) are increasingly pursuing claims against various third parties in an effort to recover cash for a creditor dividend. These claims include claims for breaches of fiduciary duties against the debtor's officers and directors, claims for aiding and abetting such breaches of fiduciary duties against lenders and advisors, the recharacterisation of secured or insider debt to equity, and claims of equitable subordination of claims against officers, directors and lenders.

Another avenue of recovery is based on the Statute of Elizabeth dating to 1571, relating to transfers of assets to avoid creditors' claims, which is the historical basis for modern "fraudulent conveyance" statutes. Section 548 of the US Bankruptcy Code allows debtor estates to attack transfers of assets including leveraged asset sales (LBO's or leveraged buy-outs) as fraudulent conveyances. In addition, trustees in bankruptcy are entitled to assert state law based claims as well, including state law fraudulent conveyance statutes, specifically the Uniform Fraudulent Transfer Act (UFTA) or the Uniform Fraudulent Conveyance Act (UFCA). Most US states have adopted either the UFTA or the UFCA which often have statutes of limitation of 3 or 4 years, compared to the 2 year statute of limitation of Section 548 of the Bankruptcy Code. At the outset, it is important to note that proof of actual fraud is not a requirement for recovery under any of Section 548, the UFTA or the UFCA.

In *Boyer v. Crown Stock Distribution, Inc.*, the United States Seventh Circuit Court of Appeals recently applied fraudulent conveyance statutes to a debtor's pre-bankruptcy sale of all of its assets. In Crown Stock, several years prior to the bankruptcy filing, the debtor and its shareholders agreed to sell all of the debtor's assets for $6 million to "newco", formed by the buyer to purchase the assets of the debtor. Of the purchase price, $3.1 million was paid in cash and $2.9 million was paid in the form of a promissory note from the buyer to the debtor. The $3.1 million in cash was immediately distributed to the debtor's shareholders. Moreover, the cash was generated in the first instance by a bank loan to "newco" for $3.1 million, in exchange for a pledge of all of the company's assets. The $2.9 million promissory note owed by the buyer to the debtor was also secured by all of the company's assets, although subordinate to the bank's security interest on the $3.1 million debt. Contemporaneously with this sale of assets, the debtor also transferred approximately $600,000 of operating cash to a non-corporate account to fund an additional dividend to shareholders.

Newco was not successful, the company defaulted on the notes and it ultimately filed for bankruptcy. All of Newco's assets were sold in a Chapter 11 Section 363 sale for $3.7 million. The sale proceeds were used largely to pay off the secured debt associated with the pre-bankruptcy sale transaction. The chapter 7 trustee then attacked the pre-bankruptcy sale transaction as a fraudulent conveyance under Indiana's version of the UFTA, which had a 4 year statute of limitations. The Trustee could not assert a claim under Section 548 of the Bankruptcy Code since its two-year statute of limitation had passed. The Bankruptcy Court determined that Newco, in the pre-bankruptcy sale transaction, had become obligated for $6 million, but received assets worth no more than $4 million, presumably based on the fact that the assets were sold for $3.7 million in bankruptcy. The Court further concluded that as a result of Newco's purchase and the attendant debt obligations, Newco had unreasonably small remaining assets in relation to the business and that Newco was on "life-support from the get-go". Accordingly, the Bankruptcy Court concluded that the debtor did not receive "reasonably equivalent value" in exchange for its transfer of assets.

On appeal, the United States 7th Circuit Court of Appeals collapsed the transactions relating to the sale and concluded that despite being an "asset sale", the shareholders had in essence sold the business enterprise to the buyer and received all the benefit from the sale, in the form of the $3.1 million cash payment, a $2.9 million note and a $600,000 dividend from the debtor's cash. Moreover, the Appeals Court agreed with the Bankruptcy Court that as a result of the transaction, the debtor had too much debt and too little assets to avoid a "likely … plunge … into bankruptcy".

The Court ruled that the trustee was entitled to a judgment for the $3.1 million cash payment, any payments made on the $2.9 million note and for the $600,000 dividend payment, which amounts could be recovered from the shareholders. Interestingly, the trustee did not pursue claims against the lender who made the $3.1 million loan to Newco that was the source of the cash for the payment to shareholders. Since the lender loaned $3.1 million in exchange for a pledge of assets as security, there likely was no sustainable claim that there was a transfer of assets to the lender for less than "reasonably equivalent value" or "fair consideration", as required to prevail on claims under Section 548, or under the UFTA or UFCA.

The *Crown Stock Distribution* case stands as evidence that unsecured creditors are using old and new legal theories to assert claims against various third parties in an effort to create value for claims, and that courts will order recoveries in appropriate cases.

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