First Circuit Affirms Dismissal of Fraudulent Transfer and Fiduciary Duty Claims

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This article discusses a recent U.S. Court of Appeals for the First Circuit decision holding that the debt-financed purchase of a business was not a fraudulent transfer and did not violate the fiduciary duty of the company's directors.

"[T]he largely debt-financed purchase of a family-owned [business] was not a fraudulent [transfer] and did not amount to a violation of the fiduciary duty of the company's directors," held the U.S. Court of Appeals for the First Circuit on December 4, 2017.[1] According to the court, "the bankruptcy court's factual determinations [after a five-day trial were] not clearly erroneous," and were supported by "sufficient facts to support its conclusions" despite a lack of specific findings relating to two debtor subsidiaries.[2]

RELEVANCE

Courts have recently rejected fraudulent transfer and fiduciary duty attacks on transactions undermined by unforeseen events and the "global financial crisis" of 2009-10.[3]

FACTS

The holding company debtor ("Holdco") and its two operating subsidiaries ("Sub 1" and "Sub 2") were part of an administratively consolidated Chapter 11 case. A private equity firm ("P") had created Holdco after acquiring the stock

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[1] *In re Irving Tanning Co.*, 876 F.3d 384, 387 (1st Cir. Dec. 4, 2017).

[2] *Id*.

[3] *Id*., at 388. *See*, *e.g.*, *In re ATP Oil & Gas Corp.*, 2017 U.S. App. LEXIS 21337 (5th Cir. Oct. 27, 2017) (affirmed dismissal of trustee's fiduciary duty and fraudulent transfer claims based on payment on stock dividends and payment of cash bonuses to officers during the two years preceding bankruptcy after a major oil spill in 2010 and moratoria on further drilling); and *In re Lyondell Chem. Co.*, 2017 Bankr. LEXIS 1097, *6 (Bankr. S.D.N.Y. April 21, 2017) (after a lengthy trial, trustee failed to prove insolvency, actual fraud or fault to support breach of fiduciary duty claims; debtor had been "buffeted by unplanned and . . . unforeseeable events . . . and the effect of the Great Recession at the end of 2008.").

of another leather manufacturer ("Irving") in the same business as Sub 1. P believed that "consolidating [Sub 1] and Irving could lower the cost of leather production and allow the surviving entity's products to reach new markets."[4] Eventually, P created Holdco and transferred its "stake in Irving to it."[5]

Holdco was the sole shareholder of Sub 1, which was in turn the sole shareholder of Sub 2. Holdco had acquired Sub 1 from a family group of shareholders, who had owned it for over 100 years and who sold it to Holdco in late 2007 for cash, a note, Holdco stock, the assumption of some of Sub 1's liabilities and the granting of employment contracts for two shareholders.[6]

The directors of Sub 1 carefully "considered the transaction" with Holdco before approving it.[7] They received "financial advice from . . . a management consulting firm; accounting advice from an outside public accountant; and legal advice from" Sub 1's counsel.[8] Evidence showed "that the transaction would create a stronger entity long-term. Financial projections [showed] that the transaction was likely to succeed, though [Sub 1] recognized that the transaction involved risk."[9]

Holdco financed the transaction with a loan from its primary lender, secured by the assets of Holdco and its four subsidiaries. Holdco was "able to pay its bills" immediately after the transaction, but encountered financial problems in early 2008 when "the global financial crisis" started.[10]

By 2010, Holdco was insolvent, causing it and the other debtors to file Chapter 11 petitions in late 2010. A litigation trust acquired the debtors' claims after the bankruptcy court confirmed a Chapter 11 plan on Oct. 18, 2012.

THE LOWER COURTS

The litigation trustee sued the shareholders and the directors of Sub 1. It sought to void the transactions as a fraudulent transfer and hold the directors liable for breach of their "fiduciary duties by approving" the transaction with Holdco.[11]

[4] 876 F.3d at 387.

[5] *Id.*, at 388.

[6] *Id.*, at 387.

[7] *Id.*, at 388.

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] *Id.*, at 389.

The bankruptcy court, after a five-day trial with a voluminous record, ruled for the defendants "on every count."[12]

Despite the bankruptcy court's failure to make "specific findings with respect to" Sub 1 and Sub 2 when finding that the sale of Sub 1 was not a fraudulent transfer and that its directors had not breached their duties, the trustee never asked for additional findings.[13]

The trustee appealed to the district court, arguing that "the bankruptcy court's decision was insufficiently supported by findings of fact and was clearly erroneous."[14]

Affirming, the district court disagreed, holding that any mistakes made by the bankruptcy court "were harmless and that [the trustee] had not shown any breach" of fiduciary duty.[15]

THE COURT OF APPEALS

The court overlooked the bankruptcy court's lack of detailed findings because the factual findings in the record were sufficient and because the trustee failed to ask the bankruptcy court for more findings.

Still, the First Circuit conceded that the bankruptcy court ordinarily should have analyzed whether the "transaction was fraudulent with respect to the individual debtors," Sub 1 and Sub 2, not just Holdco.[16]

Under the Uniform Fraudulent Transfer Act ("UFTA"), which the trustee relied on here, "each entity needs to be evaluated separately."[17] "[W]hether the transaction was fraudulent with respect to a separate entity [i.e., Holdco] does not adequately protect [the] interest" of the creditors of Sub 1 and Sub 2.[18]

Holdco—No Fraudulent Transfer

According to the First Circuit, "the bankruptcy court clearly stated the evidence on which it [relied, and] it found the necessary facts," none of which was "clearly erroneous."[19]

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[12] *Id.*

[13] *Id.*

[14] *Id.*

[15] *Id.*

[16] *Id.*, at 390.

[17] *Id.*

[18] *Id.*

[19] *Id.*, at 391.

First, Holdco "received reasonable value"—it paid cash to shareholders, made life insurance payments and non-competition agreement payments "in exchange for [Sub 1]."[20]

More important, "the value of [Sub 1] stock . . . exceeded the total transferred to the shareholders."[21] Sub 1 "had $44.2 million in total equity at the time of closing, and Holdco paid $27.4 million for it," giving the bankruptcy court "a reasonable basis for its determination," which the First Circuit refused to "second guess."[22]

Nor had the trustee shown that Holdco was "undercapitalized" or that it "would be unable to pay its debts as they came due following the transaction."[23] A lender's credit report, available cash and assets, plus credible testimony as to the witnesses' belief regarding Holdco's ability to pay its bills, supported the bankruptcy court's fact findings.

Subs 1 and 2—No Fraudulent Transfers

The trustee also failed to prove either undercapitalization or belief by those debtor subsidiaries that they would be unable to pay their debts as they became due.[24] Because Holdco "was a holding company with no business operations of its own," nothing in the record would support the trustee's allegations "if in fact their corporate parent/grandparent [Holdco] was not subject to either of those taints . . . ."[25]

Despite the theoretical possibility that the subsidiaries were insolvent or undercapitalized, the trustee "provided no evidence that this theoretical possibility was true."[26]

No Actual Fraudulent Intent

The bankruptcy court "found that the defendants—who controlled [Sub 1 and Sub 2] did not act with intent to defraud."[27] Because actual fraud had to be proved "by clear and convincing evidence," a "largely factual [finding] based on credibility," the First Circuit declined to review the bankruptcy court's

[20] *Id.*

[21] *Id.*, at n. 6.

[22] *Id.*, at 391.

[23] *Id.*

[24] *Id.*, at 392.

[25] *Id.*

[26] *Id.*, at 393 n. 9.

[27] *Id.*, at 394.

finding, particularly when the trustee produced "no direct evidence of actual fraud" and when the "circumstantial evidence [showed] that [Sub 1 and Sub 2] received reasonably equivalent value" in the transactions.[28]

Substantial testimony and "documents in the record" showed "that the merger had the potential to create efficiencies, expand markets, lessen costs and allow the [insider] family to continue its connection with the [Sub 1] brand into another generation."[29]

Only "two [purported] badges of fraud were present: the sale was made to [Sub 1's] insiders and the transfer involved the sale of substantially all of [Sub 1's] assets."[30]

Unless Sub 1 were successful, though, both debtor subsidiaries could not create efficiencies, expand markets and allow the insider family defendants to continue their connection with the Sub 1 brand.[31]

No Breach of Fiduciary Duty

In the view of the First Circuit, "the findings of fact supporting [the bankruptcy court's] fraudulent [transfer] analysis . . . foreclose the possibility of fiduciary duty liability."[32] The trustee alleged that the directors "breached their duty of care by failing to properly investigate the transaction and violated their duty of loyalty by self-dealing and approving prohibited distributions," but Holdco's "insolvency is the only specific harm alleged to have resulted from these breaches."[33]

Still, the bankruptcy court properly found that the trustee failed to prove that "the purported breach proximately caused the harm suffered."[34]

In fact, the trustee failed "to convincingly link" Holdco's "inability to pay its bills as they came due in 2009" with the "2007 payments to the Shareholder Defendants."[35] Testimony and "an expert report" showed that "unforeseeable increases in chemical and energy prices, along with the financial crisis,

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[28] *Id.*, at 393 n. 10.

[29] *Id.*

[30] *Id.*, at 394 n. 11.

[31] *Id.*

[32] *Id.*, at 394.

[33] *Id.*

[34] *Id.*

[35] *Id.*

significantly contributed to [Holdco's] insolvency," confirmed by "board meeting minutes."[36]

Because "the transaction did not cause the insolvency of [Holdco]," the same result followed for Sub 1, because Holdco "was a holding company without any operations of its own."[37]

COMMENT

Irving Tanning shows the advantages of a fair trial. The defendants made a strong factual record of care, diligence and thoughtful consideration by business people who were later confronted by unforeseeable events. Insolvency here did not follow from either mismanagement or self-dealing.

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[36] *Id.*

[37] *Id.*