ALERTS

Seventh Circuit Holds Diversion of Asset Sale Proceeds to Be Fraudulent

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A corporation's asset sale "was structured [by its insiders] so as to fraudulently transfer assets in order to avoid paying [a major creditor] what it was owed," held the U.S. Court of Appeals for the Seventh Circuit on March 22, 2016. *Continental Casualty Co. v. Symons*, 2016 WL 1118566, at *6 (7th Cir., March 22, 2016). Affirming the district court's 136-page order and judgment against the corporate defendant and its insiders, the Seventh Circuit held: (1) the defendant liable for breach of contract; (2) the insiders "liable as transferees under" Indiana's version of the Uniform Fraudulent Transfer Act ("UFTA"); and (3) two individual insiders "liable under an alter-ego theory." *Id.* at *1.

Relevance

The asset sale in *Continental* yielded a fair price. Two other bidders offered roughly the same amount as the ultimate buyer paid, but the other bidders rejected the insiders' terms "for how the purchase price would be structured and paid." *Id.* at *3. *Continental* thus deals with the issue of whether the debtor actually received reasonable value, not whether the asset buyer paid a fair price. *See, e.g.*, *In re Craig*, 144 F.3d 587, 593 (8th Cir. 1998) (debtor made indirect fraudulent transfer to spouse when he directed that loan funds pay for house titled in wife's name). Because the corporate defendant received only $16.5 million of the $40 million sale proceeds, the court dealt with the issue of who was liable for the diversion of roughly $24 million of sale proceeds.

Facts

The corporate defendant ("D") bought a crop insurance business in 1998 from Continental Casualty Company ("Continental"). Under the contractual formula, D owed Continental roughly $25 million. Shortly thereafter, D sold the business to "A" for $40 million. The insiders insisted that the purchase price be paid as follows: $16.5 million to D; and the remaining $24 million to insiders. A agreed. The "key questions in this protracted litigation are whether the payments to [the insiders] were fraudulent transfers undertaken to evade [D's] debt to Continental, and if so, which entities and persons may be held liable." *Id.* at *1.

The district court held that certain insiders were liable to Continental, along with D, for breach of contract; the insiders were liable as transferees under the UFTA; and at least two of the insiders were "liable under an alter-ego theory." *Id.* at *5.

Fraudulent Transfer

The Seventh Circuit affirmed the findings that D had diverted the sale proceeds with actual intent to defraud Continental. In any event, said the court, D had received less than reasonably equivalent value when it was insolvent, making the diversion constructively fraudulent.

Constructive Fraud

A paid $40 million for D's insurance business, but D received only $16.5 million of the purchase price, with the remainder being "siphoned off" to insiders. In short, "this was a diversion of purchase-money funds, leaving [D] with less than reasonably equivalent value." *Id.* at *6. Moreover, "the structure of the transaction — specifically, the sham non-competes and overpriced reinsurance treaty," ostensibly the rationale for the diversion of sale proceeds, "had been 'proposed and driven' by [the insiders]." *Id.* Because D "received less than half the value of what it was selling, with the rest of the money going to insiders instead," the deal "thus met all the elements of" a constructively fraudulent transfer — "an open claim, insolvency, and a sub-value transfer." *Id.* at *7.

Actual Intent to Defraud

The district court found that D had diverted the sale proceeds with actual "intent to defraud a creditor [i.e., Continental]." *Id.* at *7. The Seventh Circuit accepted the district court's reliance on circumstantial evidence to show the requisite intent. *First*, D had diverted the proceeds after Continental had threatened legal action unless it was paid. *Id.* at *7. *Second*, D was insolvent. *Id.Third*, because D "received less than half the value of [the assets sold, it was left] unable to satisfy any execution of its debt to Continental." *Id.* at *8. *Fourth*, the transaction was extraordinary. It "differed from customary methods by transferring purchase-price consideration to unjustified non-competes and reinsurance." *Id.Fifth*, D "received inadequate consideration [for] the transfer, "less than 50% of the going market price." *Id.Finally*, the diversion of sale proceeds "was essentially between family members," D's affiliates. "The existence of several of these [so-called 'badges of fraud'] may warrant an inference of fraudulent intent" under applicable Indiana law. *Id.* at *7, citing *Hoesman v. Sheffler*, 886 N.E.2d 622, 630 (Ind. Ct. App. 2008).

The purported "non-competes" for which two of the insolvent insider affiliates had received sale proceeds "were a sham." *Id.* at *9. As the court explained, "the non-competes only make sense as a fraudulent diversion of the purchase money for the crop-insurance business, not as a purchase of good will and legitimate protection from competition." *Id.*

The diversion of sale proceeds for a "reinsurance treaty" was also a sham. The insiders "suggested" this $15-million diversion that was "outside industry norms," making it "unjustified and overpriced." *Id.* at *10.

Transferee Liability

Two of the individual insiders argued that they could not be held liable because the UFTA "does not account for 'participation' liability." *Id.* at *11. Instead of resolving whether the two individuals could be liable as "transferees" under the UFTA, the court instead relied on "veil-piercing principles," placing the two individuals "on the hook without broadening beneficiary liability under the [Indiana] UFTA to include vicarious or participatory liability." *Id.* at *12.

Substance over Form

The court rejected the insiders' "very formalistic argument that the money paid to" them "never belonged to [D] so it couldn't really have been transferred fraudulently." *Id.* Although they had essentially argued that D had not disposed of its own property, the court relied on the UFTA's definition of a transfer: "Disposing of or parting with an asset or an interest in an asset, *whether the mode is direct or indirect*." *Id.*, citing Indiana UFTA 32-18-2-10 (emphasis added); *HBE Leasing Corp. v. Frank*, 48 F.3d 623, 638 (2d Cir. 1995) (lower court "correctly disregarded the form of this transaction and looked instead to its substance"); *In re Unglaub*, 332 B.R. 303, 316 (Bankr. N.D. Ill. 2005) ("For purposes of the [UFTA], equity looks to the substance of the transaction rather than its form.") Because the transaction here "was structured to keep more than half the purchase price away from [D] and in the hands of the [insiders]," their "sleight of hand ... was the very means of the fraud." *Id.* at *13.

Alter-Ego Liability

Two of the individual insider defendants challenged "their alter-ego liability," but the Seventh Circuit deferred to the district court's fact finding. First, the entire transaction was unfair. The insiders "structured the sale of the business to [A] to syphon assets away from [D] to evade the debt to Continental, which is what the non-competes and reinsurance ... accomplished." *Id.* at *14. Second, the insiders "ignored, controlled, and manipulated the corporate forms" of the various insider affiliates and "operated the corporations as a single business enterprise such that these entities were mere instrumentalities" of the insiders. The court agreed that veil-piercing is often "applied to closely held corporations," but a company's non-private status "isn't a necessary condition for an alter-ego claim." *Id.* at *16. Not only have other courts disregarded the form of public companies, but the public company insiders here, in any event, had "been delisted from the NASDAQ." *Id.*

Finally, the record supported the district court's alter-ego liability findings. "Corporate formalities were both cosmetic and ignored," said the Seventh Circuit. The corporate affiliates "all gave regulators the same address in Indiana as their actual base of operations ... , assets were comingled — indeed, the corporations all seem to have aided one another with some degree of impunity. [Insider] family members received millions of dollars in no-interest, unsecured loans from their companies. Finally, [one individual insider] was the principal agent of all the relevant companies and the architect of the sale." *Id.* In short, because the individual insiders were easily liable under an alter-ego theory, the court never had to reach the issue of whether they were liable as transferees under the UFTA.

Comment

Continental is consistent with other appellate decisions that look "to substance, rather than form, and protect creditors from any transaction … that [has] the effect of impairing [creditors'] rights." *Boyer v. Crown Stock Dist., Inc.*, 587 F.3d 787, 792 (7th Cir. 2009); *Orr v. Kinderhill Corp.*, 991 F.3d 31, 35 (2d Cir. 1994) (when transfer only a step in a general plan, court must view whole plan with all implications); *Voest-Alpine Trading USA Corp. v. Vantage Steel Corp.*, 919 F.3d 206 (3d Cir. 1990) (collapsed sham transactions intended to defraud creditors).

Authored by Michael L. Cook .

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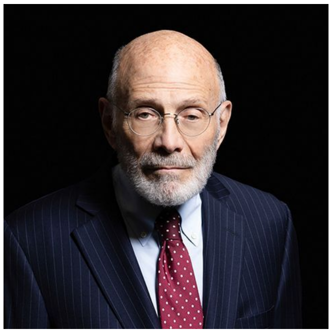

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