Moller-Foltz
American Inns of Court

Team 2

November 15, 2011

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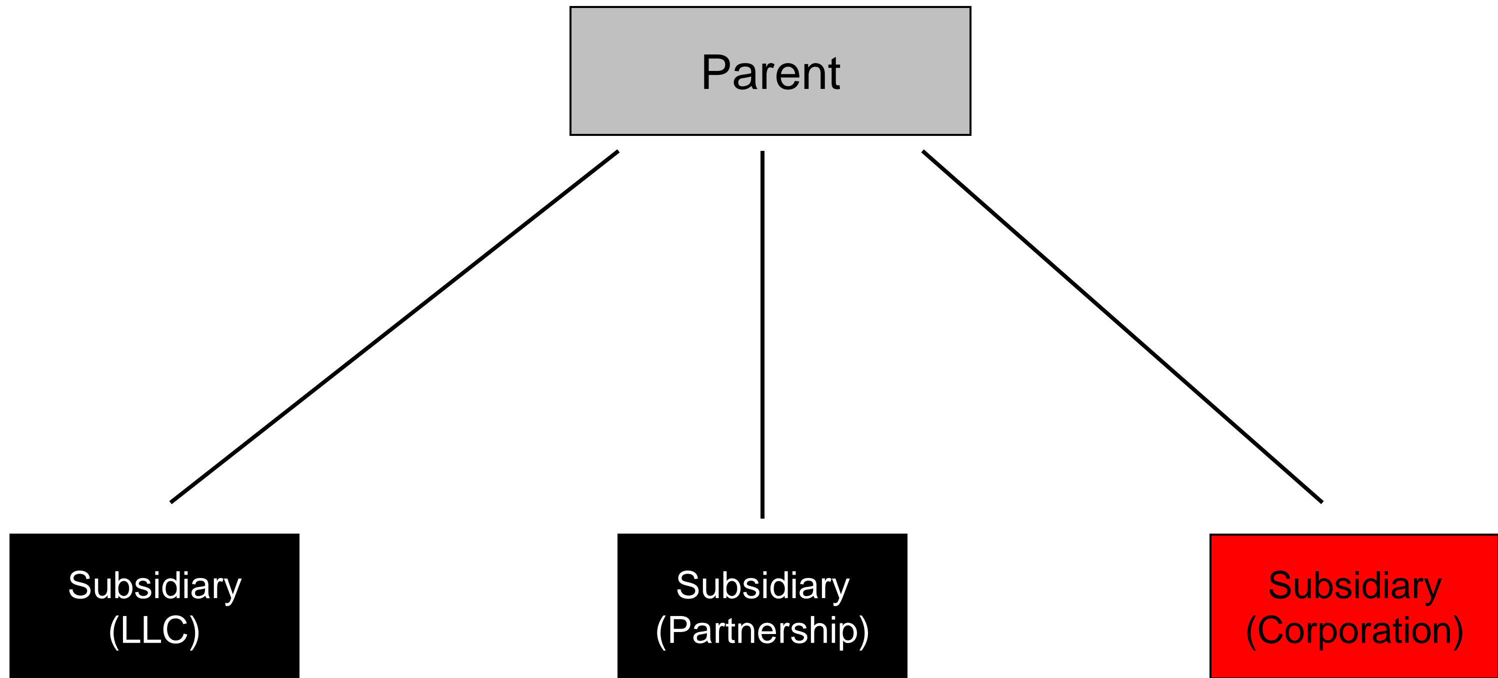
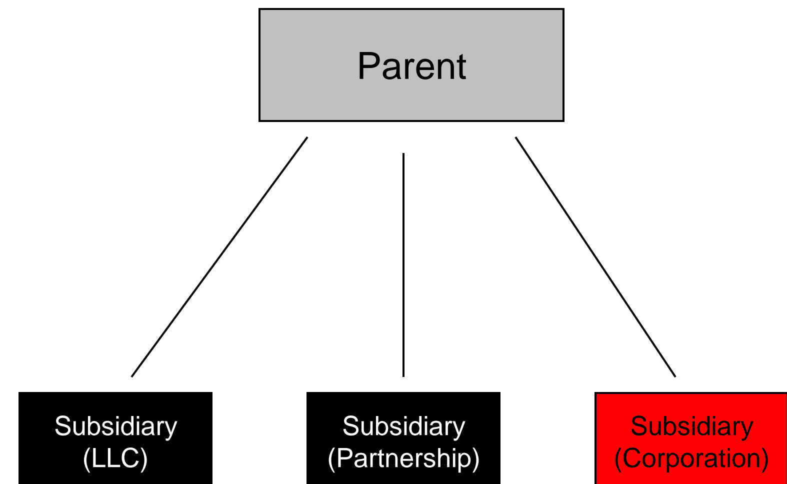
The Problem



Overview of Issues

- **Fiduciary Duties**
- **Ethical Issues**
- **Liability**
  - Alter Ego
  - Other Veil-Piercing Theories
  - Environmental and Other Unique Liabilities
  - Substantive Consolidation
- **Scrutiny of Transactions**
  - Fraudulent Transfer
  - Insider Preference
  - Equitable Subordination
- **Tax and Financing**



Group I

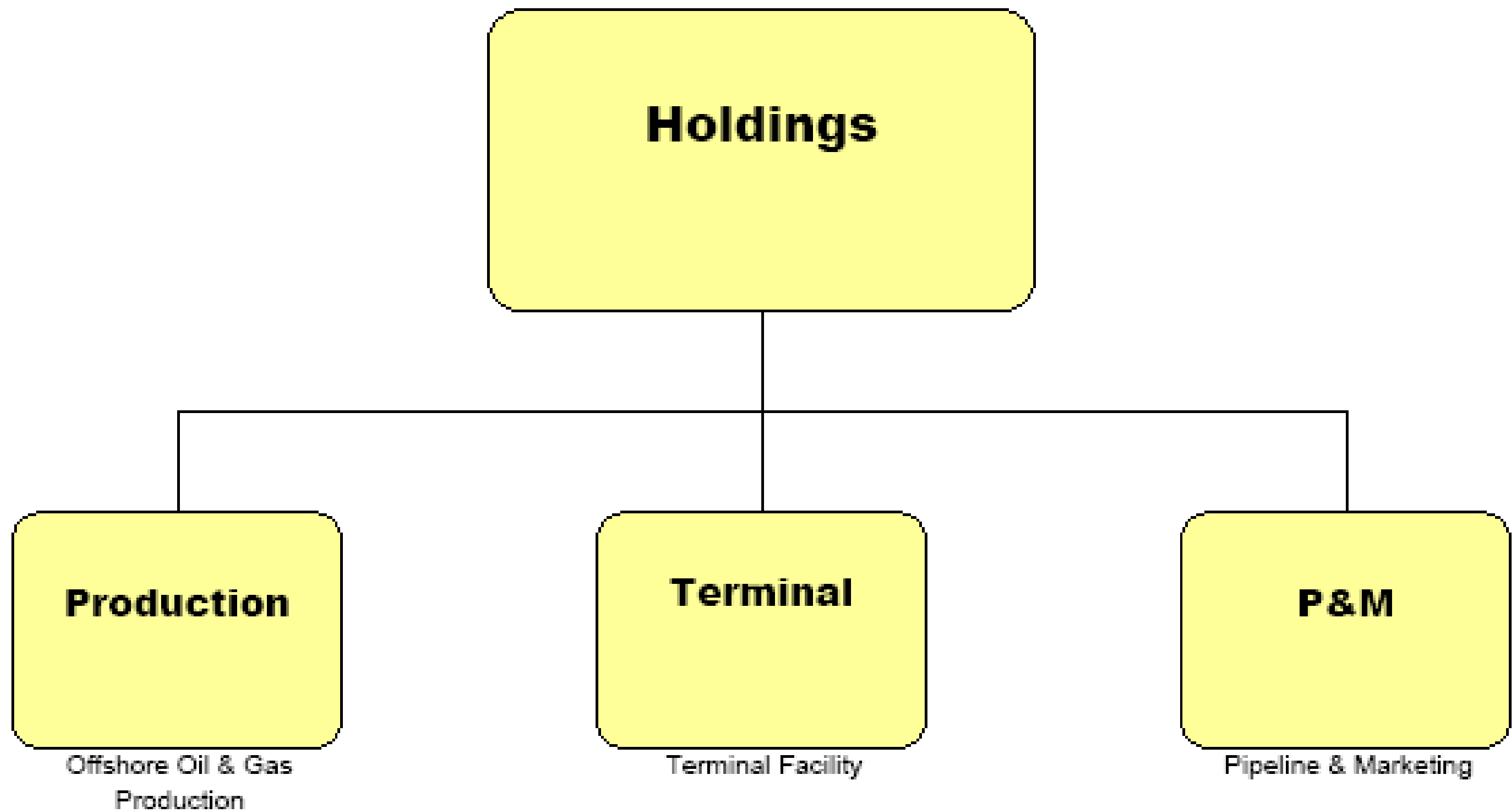
- **Managing Risk: Insolvency Advice for the Financier**

Group II

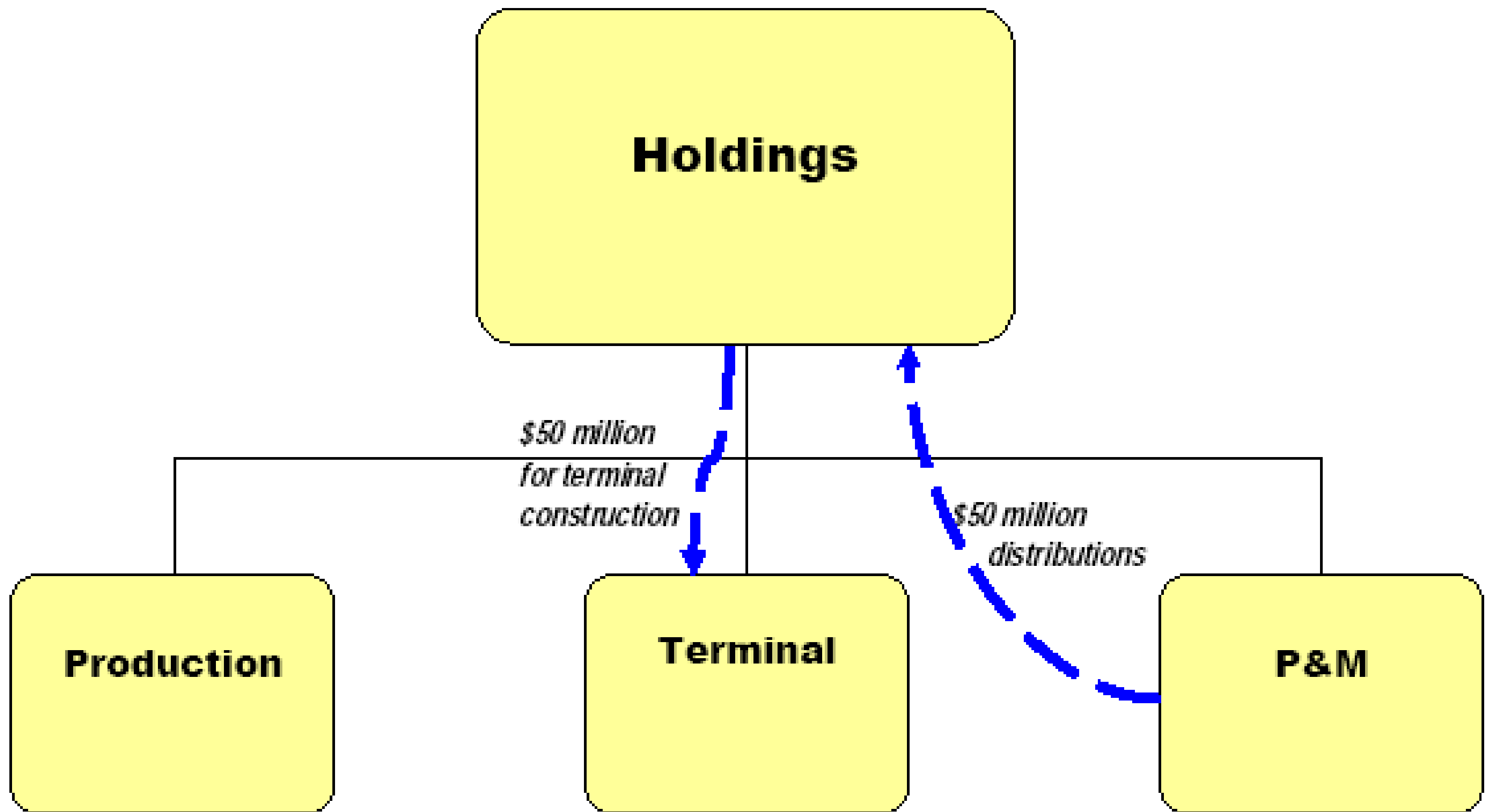
- **Walking the Minefield: Advice on the Zone of Insolvency**

Group III

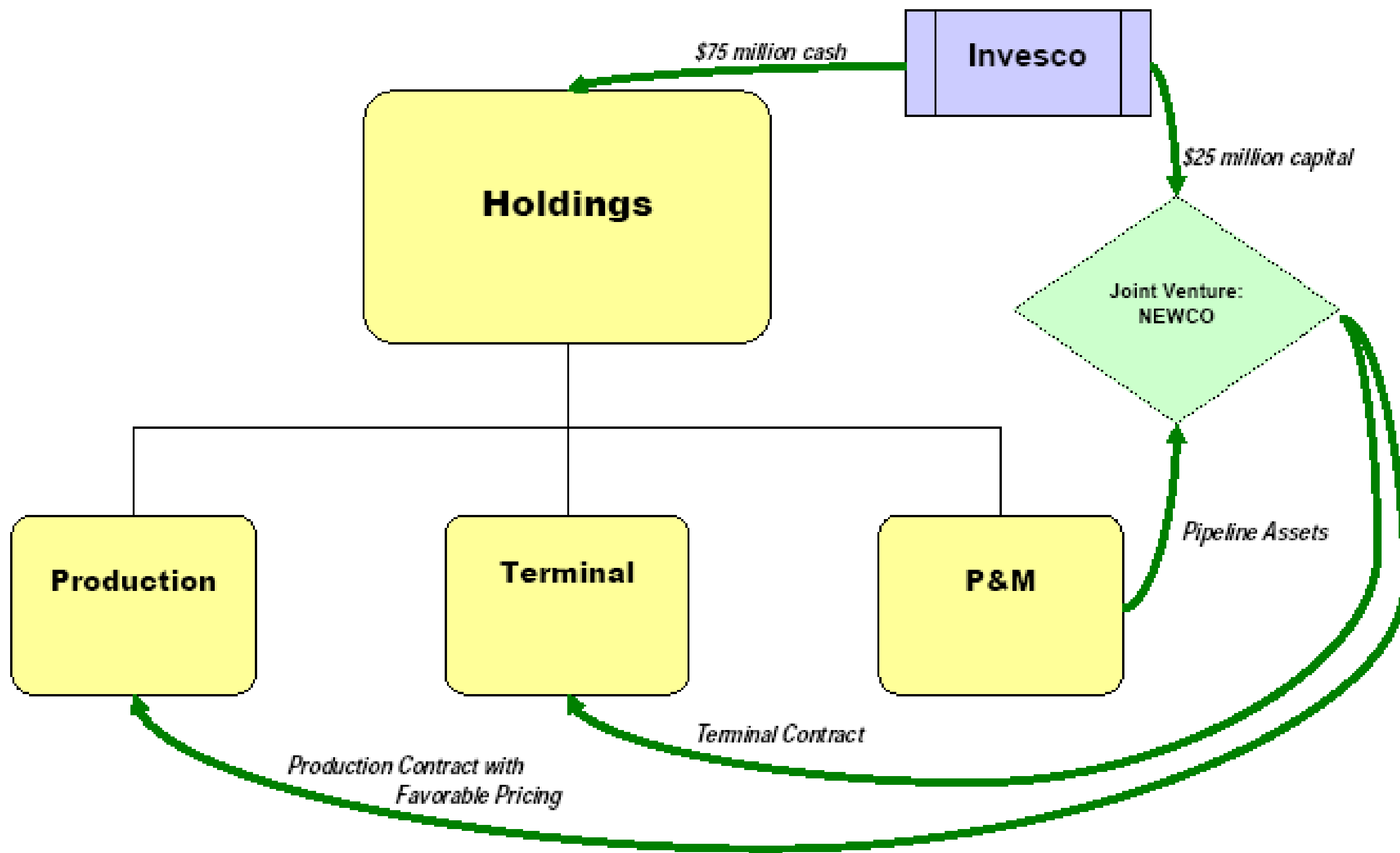
- **Point of the Sword: Avoidance Litigation**


Holdings
Production
Offshore Oil & Gas Production
Terminal
Terminal Facility
P&M
Pipeline & Marketing

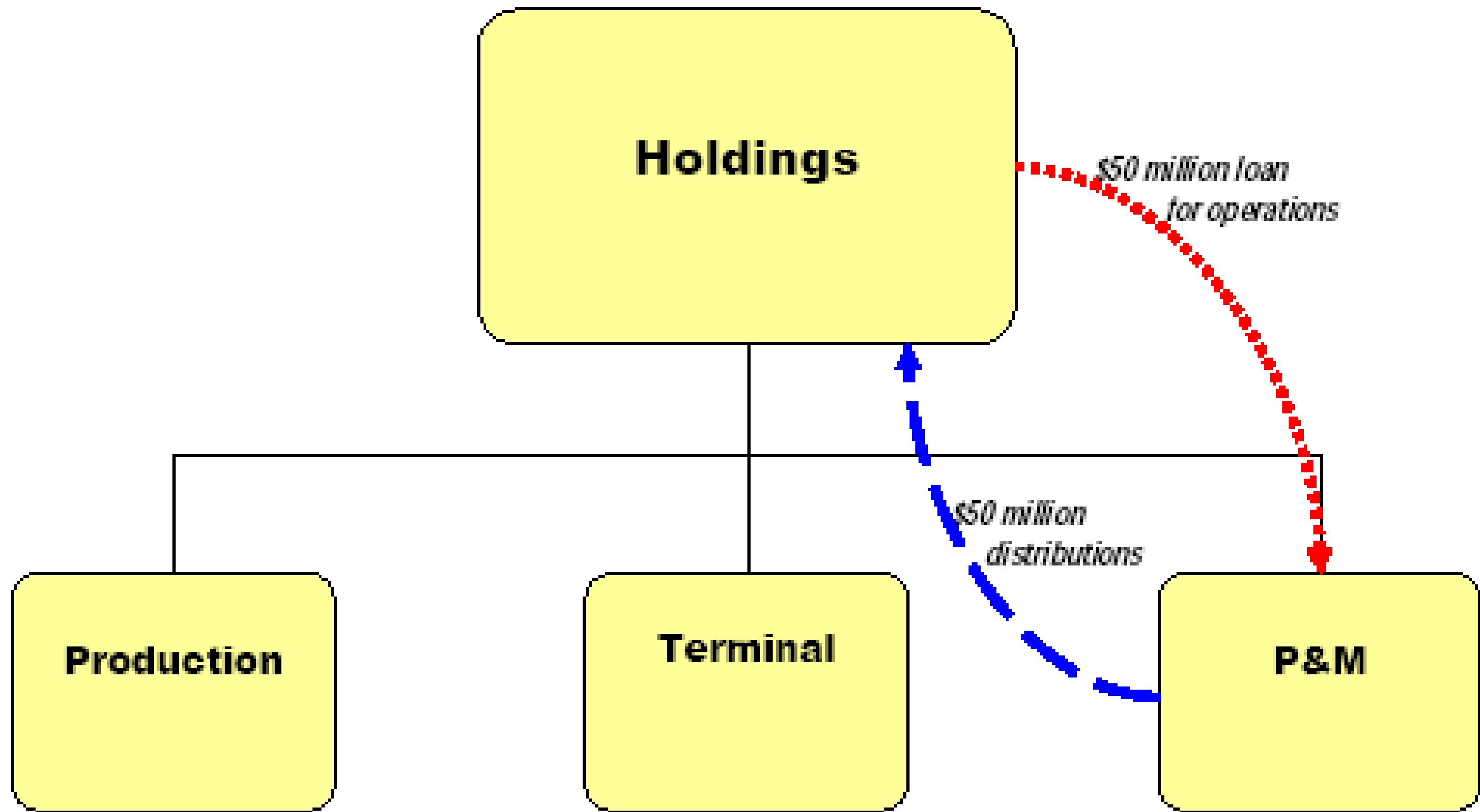
- **Holdings has transferred $50 million to Terminal.**
  - Used by Terminal to construct Terminal
  - Reflected as intercompany payables from Terminal
  - No note or other evidence of debt
- **P&M has distributed $50 million to Holdings.**
  - Generated by historically profitable operations
  - Dividend never declared
  - Reflected as payable owed by Holdings to P&M


Holdings
$50 million
for terminal
construction
$50 million
distributions
Production
Terminal
P&M

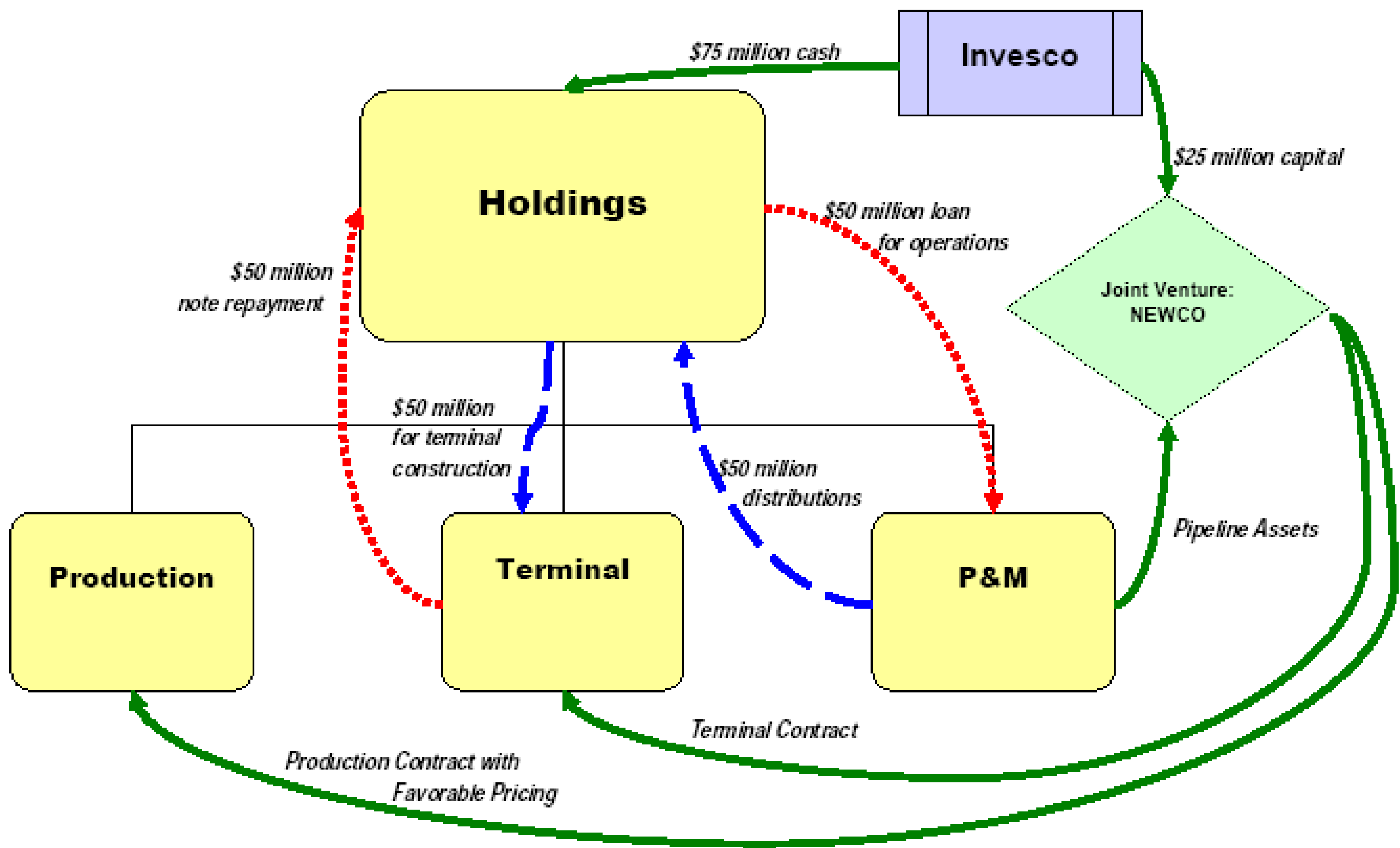
- **On December 31, 2009 Holdings entered into a venture with Invesco, a Wall Street financial firm. The terms of this transaction (the Transaction) included the following:**
  - Invesco contributed $25 million of capital to Newco, the venture formed between Invesco and Holdings.
  - Invesco paid $75 million to Holdings.
  - A portion of the pipeline assets of P&M were contributed to Newco.
  - Newco entered into a terminalling contract with Terminal.
  - Production entered into a contract to sell production to Newco under a pricing structure favorable to Newco.


$75 million cash
Invesco
Holdings
$25 million capital
Joint Venture:
NEWCO
Production
Terminal
P&M
Pipeline Assets
Terminal Contract
Production Contract with
Favorable Pricing

- **Significant environmental site related to the pipeline assets.**
- **Pipeline explosion four months prior to the Transaction.**
  - Insurance carrier had accepted coverage (with reservation of rights)
  - Insurance carrier is defending P&M in lawsuits
- **Subsequent to the Transaction, P&M operations lose money.**
  - Supported by quarterly loans from Holdings
  - Loans from Holdings now total approximately $50 million


Holdings
$50 million loan
for operations
$50 million
distributions
Production
Terminal
P&M

- **On October 10, 2011, G.C. of Holdings requests that counsel prepare a presentation for the November board meeting. The presentation must address:**
  - Class action status granted to pipeline explosion lawsuits
  - With respect to environmental site:
    - company discovers that lead battery manufacturer once used property as private landfill
    - local community organization is making claims about elevated levels of lead in area children
  - The marketing operation is hit by loss caused by rogue trader
    - P&M requests quarterly cash contribution of $12 million
    - largest amount ever requested by P&M


Invesco
$75 million cash
$25 million capital
Holdings
$50 million loan
for operations
$50 million
note repayment
Joint Venture:
NEWCO
$50 million
for terminal
construction
$50 million
distributions
Production
Terminal
P&M
Pipeline Assets
Terminal Contract
Production Contract with
Favorable Pricing

Fiduciary Duties, Liability, Representation, and Privilege Issues in the Zone of Insolvency

When a corporation is solvent, the board owes fiduciary duties to the corporation's shareholders, and creditors are left to protect their rights by contract. When a corporation is in or approaches insolvency, however, most authorities now state that the board owes duties to or for the benefit of creditors. These authorities force boards in restructuring situations to both monitor the solvency of the company and to assess the impact that their decisions will have on both creditors and shareholders.

In the parent-subsidiary context, where the subsidiary is potentially insolvent, counsel must be alert to the possibility that the subsidiary's allegiance may shift from exclusively favoring the parent-shareholder to also include consideration of the subsidiary's creditors, and the implications that has for who counsel has identified as the client, and for maintaining the attorney-client privilege.

I. FIDUCIARY DUTY ISSUES

- **Solvent Company:** Oil & Gas Holdings, Inc.
  - **What fiduciary duties are owed by the Board of Oil & Gas Holdings, Inc.?**
    - State law governs questions of fiduciary duties.
      - Duty of care
        - (tempered by the business judgment rule)
      - Duty of loyalty
  - **Does the Board of Oil & Gas Holdings, Inc. owe fiduciary duties to its creditors?**
    - Directors of a solvent company owe fiduciary duties exclusively for the benefit of the company's shareholders. Thus, actions taken by directors are expected to benefit shareholders. *See Prod. Res. Grp., L.L.C. v. NCT Grp., Inc.*, 863 A.2d 772, 787 (Del. Ch. 2004).
    - Typically, no duties are owed to creditors other than those granted by express agreement. This is because courts believe that creditors are capable of protecting themselves and are further protected by fraudulent conveyance and bankruptcy law. *See Prod. Res. Grp., L.L.C. v. NCT Grp, Inc.*, 863 A.2d 772, 787 (Del. Ch. 2004).
- **Insolvent, Non-bankrupt Company:** P&M, Inc.
  - **How does P&M, Inc.'s Board determine whether the company is insolvent?**
    - Determining insolvency can be difficult.
      - Delaware: (1) deficiency in assets below liabilities with no reasonable prospect that business can continue, or (2) inability to meet maturing obligations.

- **What fiduciary duties are owed by the Board of P&M, Inc.?**
  - The duties themselves remain relatively the same—to exercise informed and good faith business judgment in the best interest of the corporation.
  - Although the duties are owed to the corporation, as opposed to any particular constituency, to be fully informed, the Board should consider how its decisions will affect creditors and the parent shareholder.

- **Does the P&M, Inc. Board owe fiduciary duties to creditors?**
  - Since P&M, Inc. is insolvent, persons with standing to sue for breach of fiduciary duty may include creditors as well as shareholders.
  - P&M, Inc.'s precarious financial condition can create incentive to disadvantage creditors.
  - *Credit Lyonnais* has been read by some to suggest that duties extend to creditors when the company is in the "zone of insolvency." *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 WL 277613 (Del. Ch. Dec. 20, 1991).
  - *Gheewalla* clarified that creditors can assert derivative claims on behalf of the corporation but no direct claims for breach of fiduciary duty. *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101-02 (Del. 2007).
  - *Credit Lyonnais* and *Gheewalla* create a new class of plaintiffs—*i.e.* creditors, but they also provide cover for directors who elect not to support risky behavior.
  - Some courts have suggested that this duty expands to creditors when the company is on the verge of insolvency. See *Weaver v. Kellogg*, 216 B.R. 563, 583-84 (S.D. Tex. 1997).
  - However, creditors of an insolvent LLC do not have derivative standing to sue managers for breach of fiduciary duties. *CML V, LLC v. Bax*, 6 A.3d 238 (Del. Ch. 2010).

II. LIABILITY ISSUES

- **Could application of the alter ego theory create liability for Oil & Gas Holdings, Inc. to the creditors of P&M, Inc.?**
  - Factors evidencing a lack of separateness between Oil & Gas Holdings, Inc. and P&M, Inc.:
    - Oil & Gas Holdings, Inc.'s financing of its subsidiary P&M, Inc.
    - Common officers and Board Members
    - P&M, Inc. operating with grossly inadequate capital.
    - Oil & Gas Holdings, Inc. using P&M, Inc.'s property as its own (pipeline assets for the Newco venture).

- Alter Ego
  - Governed by law of state of incorporation of the corporation whose veil is to be pierced.
  - Elements:
    - Lack of separateness, and
    - Use of corporate structure is wrongful and causes injury.

- **What actions, if taken by Oil & Gas Holdings, Inc., could create liability to creditors of P&M, Inc.?**
  - Current creditors of P&M, Inc. include:
    - class-action plaintiffs in pipeline explosion litigation
    - potential personal injury claimants concerning adverse health effects caused by elevated levels of lead in area children
    - Oil & Gas Holdings, Inc. ($50 million in quarterly loans for operations)
    - EPA (for cleanup costs for environmental site)
    - Oil & Gas Holdings, Inc.'s directors could be held liable for directing P&M, Inc. to use its assets for the sole benefit of Oil & Gas Holdings, Inc.

- **Does Oil & Gas Holdings, Inc. have any liability exposure for the environmental cleanup costs for P&M, Inc's site that has been discovered to have lead contamination?**
  - General alter-ego theories are available to regulators.
  - Under CERCLA, Oil & Gas Holdings, Inc. can be liable as an operator even if the facility is owned by P&M, Inc.
    - In order for liability to exist:
      - Oil & Gas Holdings, Inc. must be a direct participant in the actions creating liability.
        - It was not, since the site was contaminated by a local lead battery manufacturer who used the property as a private landfill.
      - Oil & Gas Holdings, Inc. must exercise control over facility—not just control over P&M, Inc.—by managing, directing, or controlling operations related to pollution.
        - Oil & Gas Holdings, Inc. should not control decisions about leakage or disposal.
        - Oil & Gas Holdings, Inc. should not control decisions regarding compliance with environmental law.
      - Successor liability can apply if there is a continuity of ownership after a sale of assets.
      - Control liability can be created by consolidation of functions.

- **Should Oil & Gas Holdings, Inc. make an additional loan of $12 million to P&M, Inc.?**
    - Consider whether the loan would just be delaying the inevitable bankruptcy of P&M, Inc.
    - Consider whether there is any benefit to P&M, Inc. to delay its entry into bankruptcy.
    - If P&M, Inc. files bankruptcy, the $12 million loan made by Oil & Gas Holdings, Inc. would be repaid only after P&M, Inc.'s non-insider creditors have been paid in full. This could result in Oil & Gas Holdings, Inc. not recovering any payment for the loan.

- **What if Oil & Gas Holdings, Inc. takes a lien on the remaining pipeline assets of P&M in exchange for the $50 million contribution that was made to fund P&M, Inc.'s operations?**
    - Oil & Gas Holdings, Inc. made prior loans to P&M, Inc. without taking a secured position in P&M, Inc.'s assets.
    - Oil & Gas Holdings, Inc.'s Board knows that P&M, Inc. is possibly insolvent. This is the overriding reason why taking a secured position in P&M, Inc.'s pipeline assets is being contemplated.
    - Oil & Gas Holdings, Inc.'s act of taking a lien as security for payment of an antecedent debt could be viewed as an insider preference.

- **What if Oil & Gas Holdings, Inc.'s Board decides not to make the additional $12 million quarterly cash contribution that will be required to fund P&M, Inc.'s operations?**
    - P&M, Inc. could end up having to file for bankruptcy protection.

- **What if Oil & Gas Holdings, Inc.'s Board declares dividends at this time for the $50 million in distributions it received from P&M, Inc.?**
    - Improper dividends:
        - No value exchanged for payment of dividend.
        - State statutes prevent dividends unless certain financial conditions are met.
        - Joint and several liability for overseeing directors.
        - Directors can rely in good faith upon reports and information presented by officers, employees, committees and professionals when deciding if requisite financial conditions are met (i.e., surplus).

III. REPRESENTATION ISSUES

- A law firm represents Oil & Gas Holdings, Inc. When facts indicating P&M, Inc.'s possible insolvency begin to emerge, the firm must consider the following issues. The issues are fraught with uncertainty: the firm will not know until after the fact, as much as two or three years later, whether P&M, Inc. is currently insolvent or in the zone of insolvency.

  - **Whom does the firm represent?**
    - If the engagement agreement does not specify that the firm will represent both the parent and the subsidiary, the firm represents only the parent.

      "A lawyer who represents a corporation or other organization does not, by virtue of that representation, necessarily represent any constituent or affiliated organization, such as a parent or subsidiary. See Rule 1.13(a). Thus, the lawyer for an organization is not barred from accepting representation adverse to an affiliate in an unrelated matter, unless the circumstances are such that the affiliate should also be considered a client of the lawyer, there is an understanding between the lawyer and the organizational client that the lawyer will avoid representation adverse to the client's affiliates, or the lawyer's obligations to either the organizational client or the new client are likely to limit materially the lawyer's representation of the other client." — Comment 34 to Model Rule 1.7.
    - What should the law firm do?

      Make clear that the firm represents only Oil & Gas Holdings, Inc., not P&M, Inc.

  - **What if the firm's engagement agreement *does* specify that counsel represents both Oil & Gas Holdings, Inc. and P&M, Inc.?**
    - The firm cannot continue to represent both entities if Oil & Gas Holdings, Inc.'s interests are adverse to those of P&M, Inc.

      Model Rule 1.7 — a lawyer shall not represent a client if the representation involves a concurrent conflict of interest.
    - A concurrent conflict of interest exists if:

      The representation of Oil & Gas Holdings, Inc. will be directly adverse to P&M, Inc. (or vice versa); or

      There is a significant risk that the representation of one or more of the clients will be materially limited by the firm's responsibilities to another client, a former client, or a third person, or by a personal interest of the lawyer.

      The firm can represent both clients despite a concurrent conflict if:
      - The firm "reasonably believes" that the firm will be able to provide competent representation, and
      - Both Oil & Gas Holdings, Inc. and P&M, Inc. give informed consent.
    - Even if there is no actual conflict yet, the problems with the pipeline explosion, the environmental site, the debts between P&M, Inc. and Oil & Gas Holdings,

Inc., and P&M, Inc.'s potential bankruptcy mean that there may soon be a conflict.

Because Oil & Gas Holdings, Inc. and P&M, Inc. may have claims against each other and because P&M, Inc. may be insolvent, it is likely that (if the situation escalates) the firm cannot "reasonably believe" that it can provide competent representation to both. As long as P&M, Inc. was solvent, the parent and subsidiary's claims against each other did not create a conflict. But if P&M, Inc. is insolvent, the two entities' interests may no longer be aligned.

- ○ If the firm does not stop representing one of the clients before a conflict of interest arises, the firm may eventually be unable to represent either.

  Model Rule 1.9(a) — a lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client.

  Model Rule 1.9(b) — a lawyer shall not knowingly represent a person in the same or a substantially related matter in which a firm with which the lawyer formerly was associated had previously represented a client (i) whose interests are materially adverse to that person and (ii) about whom the lawyer has acquired information protected by Rules 1.6 and 1.9(c).

  Exception to Rules 1.9(a) and 1.9(b) — if the former client gives consent.

- ○ Additional issues arise because P&M, Inc. may be headed for bankruptcy.

  Oil & Gas Holdings, Inc. would likely be a creditor in P&M, Inc.'s bankruptcy.

  - The two clients' interests would then be adverse, and if the firm hasn't withdrawn from representing one of the clients, the firm can no longer represent either without the consent of both, and probably not even with consent.

  If the firm continues to represent P&M, Inc. and isn't paid, the firm will become a prepetition creditor and will be unable to represent P&M, Inc. in bankruptcy.

  If the firm continues to represent P&M, Inc. and *is* paid, the firm may have to disgorge payments as preferential transfers. The firm would then have a claim against the estate in the amount of the returned payment.

  In either scenario, the firm runs the risk of becoming a creditor.

  A firm that is a creditor is not "disinterested" within the meaning of 11 U.S.C. § 101(14) and cannot represent the P&M, Inc. if it becomes a debtor in bankruptcy. 11 U.S.C. §§ 327(a) and 1107.

  - The firm can restore disinterestedness if it waives claims, waives right to litigate preference, requires client to provide escrow money, or requires a larger retainer prior to the preference period, which the firm can then draw on the day before the filing.

- What should the firm do?
  - Withdraw from representing one of the entities before a conflict arises.
  - Make sure to perform ethical duties in withdrawal.
  - Be aware of whether the law firm risks becoming a creditor to P&M, Inc.
  - Be aware of any potential avoidable preferences.

IV. PRIVILEGE ISSUES

- **The Firm:**
  - The firm has clarified that it does not represent P&M, Inc.
  - However, three members of Oil & Gas Holdings, Inc.'s Board of Directors are also on P&M, Inc.'s Board.
  - When communicating with Oil & Gas Holdings, Inc.'s Board, the firm needs to make sure that Oil & Gas Holdings, Inc. does not inadvertently waive its attorney-client privilege.
  - Shared directors may need to be excluded from attorney-client communications.

- **General Counsel:**
  - Oil & Gas Holdings, Inc. and P&M, Inc. share general counsel.
  - General counsel communicates and shares work product with P&M, Inc.
  - If P&M, Inc. goes into bankruptcy, the privilege will be waived with respect to those communications or materials.
  - The Third Circuit has determined that when a subsidiary uses a parent corporation's in-house counsel, the co-client doctrine applies. *In re Teleglobe Commc'ns Corp.*, 493 F.3d 345 (3d Cir. 2007).
  - Under the co-client doctrine, if Oil & Gas Holdings, Inc. becomes involved in litigation against P&M, Inc., each party's communications with the shared attorney become discoverable. In *Teleglobe Communications*, the Third Circuit permitted the discovery of all documents (i) within the scope of the joint representation, (ii) on an issue of common interest, that (iii) was also the subject of the litigation.

- **How should the firm advise Oil & Gas Holdings, Inc.'s general counsel?**
  - Advise general counsel of the consequences of continuing joint representation.
  - Advise general counsel and Oil & Gas Holdings, Inc.'s Board of the potential waiver of privilege if counsel for Oil & Gas Holdings, Inc. communicates with the shared directors.
  - Assess which communications involving the general counsel, Oil & Gas Holdings, Inc., and P&M, Inc. may be discoverable if the parties become involved in litigation.

POINT OF THE SWORD: AVOIDANCE LITIGATION

Moller-Foltz American Inns of Court
Team 2 – Group 3 Presentation

November 15, 2011
Houston, Texas

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TABLE OF CONTENTS

I. INTRODUCTION 1
II. FRAUDULENT TRANSFERS 1
A. Lookback Period 1
B. Elements of Claim 1
1. Transfer 1
2. No Reasonably Equivalent Value 1
3. Distressed Financial Condition 2
C. Transactions Commonly Attacked as Fraudulent Transfers 2
1. Guarantees and Third Party Pledges of Collateral 2
a. Upstream Guarantees 2
b. Cross-Stream Guarantees 2
c. Downstream Guarantees 2
2. Other Transactions 2
D. Managing Risk 3
1. Valuation/Solvency Opinions 3
2. Allocation of Purchase Price 3
3. Credit for Value Given 3
4. Calculating the Benefit 3
5. Limitation of Guaranty 3
III. PREFERENTIAL TRANSFERS 3
A. Elements of Preference 4
1. "Transfer" Broadly Defined 4
2. Transfer Must "Prefer" Creditors 4
3. Intercompany Guarantees 4
B. Defenses 4
1. Ordinary Course of Business Transactions 4
2. No Antecedent Debt 4
3. Contemporaneous Exchange for New Value 4
4. Enabling Loans 5
5. Subsequent New Value 5
6. After Acquired Property Security Interests in Inventory/Receivables 5
IV. EQUITABLE SUBORDINATION 5
A. Misconduct 5
B. Injury to Other Creditors 5
C. Consistent With Code 5
D. Managing Risk 6
V. DEBT RECHARACTERIZATION 6
A. Theory 6
B. Test 6
1. The Name Given the Certificate Evidencing the Contribution. 7
2. The Presence of a Fixed Maturity Date. 7
3. The Source of Payments 7
4. The Right to Enforce Payment of Principal and Interest 8
C. Conclusion 8
VI. RECOVERY OF ILLEGAL DIVIDENDS 8
A. Distributions Need not be Formally Declared as Dividends 8
B. Distributions that Exceed the Distribution Limit 8
C. Meaning of Insolvency 8
D. Defenses 9
E. Liability of Shareholders 9
VII. CONCLUSION 9

POINT OF THE SWORD: AVOIDANCE LITIGATION

I. INTRODUCTION

When an entity files for bankruptcy, it has a number of weapons at its disposal to recover assets that it previously transferred to third parties. The following causes of action can be brought by a debtor (or a trustee, creditor, or creditors' committee, in some instances) to recover previously transferred assets for the benefit of the debtor's creditors.

II. FRAUDULENT TRANSFERS

Anytime a debtor files bankruptcy, any sale or other transfer of its assets is subject to review under Sections 544 and 548 of the Bankruptcy Code (the "Code") providing for recovery of fraudulent conveyances. The most basic fraudulent conveyance concern is that a bankruptcy court, with hindsight, will make a determination that the debtor did not receive a reasonably equivalent value in exchange for the transfer of its assets. This is a factual determination to be based on the preponderance of the evidence. An acquiror can attempt to insulate itself from subsequent attack by amassing evidence, including valuation opinions, that the price paid at the time of the transaction was fair. Note also that the remedy for a fraudulent conveyance may be either the recovery of the value of the property transferred or the property itself. Thus, a debtor that prevails on a fraudulent conveyance claim will seek recovery of the assets transferred if the value of that asset has increased subsequent to the time of the transfer; otherwise, it will seek recovery of the value existing at the time of the transfer. A completely different fraudulent conveyance risk is posed by a situation where the acquiror pays value to one debtor affiliate in exchange for assets from a different debtor affiliate. In such a situation, the transaction is vulnerable to attack on the grounds that the debtor that transferred its assets received nothing in exchange for such transfer. Note that simply having one debtor affiliate book an intercompany debt to another debtor affiliate does not provide sufficient "value" to the debtor whose assets are being transferred where the intercompany debt is not ultimately going to be paid in full because of an insolvency.

A. Lookback Period

The Code allows avoidance of fraudulent transfers within two years prior to the bankruptcy filing. *See* 11 U.S.C. § 548. State Uniform Fraudulent Transfer Acts permitting transfer avoidances up to four years or more may also be used to avoid transfers occurring more than two years before the bankruptcy filing. 11 U.S.C. § 544(b).

B. Elements of Claim

The debtor may avoid a transfer of the debtor's property, or an obligation incurred by the debtor, if the debtor received less than "reasonably equivalent value" in exchange and the debtor:

- was or became insolvent as a result of the transfer;
- was engaged in business, and was left with unreasonably small capital after the transfer; or
- intended to incur debts after the transfer, or believed he or she would incur debts after the transfer, that would be beyond his or her ability to pay as they matured. *See* 11 U.S.C. § 548(a)(1)(B).

If the following elements exist, a constructive fraudulent transfer has taken place. Alternately, the Debtor can recover transfers made with the intent to hinder, delay or defraud creditors.

1. Transfer

The term "transfer" is broadly construed to include any right or interest surrendered or conveyed by the debtor. For example, a promissory note transaction, pursuant to which a debtor's shareholders executed new notes that replaced those previously evidencing their borrowing from the corporation, qualified as "transfers," although the debtor did not advance any additional money to shareholders in exchange for notes. The new notes lowered the interest rate that shareholders were obligated to pay, extended payment deadlines, and extinguished the debtor's right to annual interest payments and thus to declare default if interest was not paid. This extinguished or conveyed valuable rights belonging to the debtor.

2. No Reasonably Equivalent Value

The Code defines value as "property, or satisfaction or securing of a present or antecedent debt of the debtor." 11 U.S.C. § 548(d)(2)(A). The "totality of the circumstances" test determines whether a transaction "conferred realizable commercial value [that was] reasonably equivalent to the realizable commercial value of the assets transferred." *Mellon Bank, N.A. v. Official Comm. of Unsecured Creditors of R.M.L., Inc. (In re R.M.L., Inc.)*, 92 F.3d 139, 148-49 (3d Cir. 1996); *see also 3V Capital Master Fund Ltd. v. Official Comm. of Unsecured Creditors of TOUSA, Inc. (In re TOUSA, Inc.)*, 444 B.R. 613, 654 (S.D. Fla. 2011). The totality of the circumstances surrounding the transfer

includes: (i) whether the transaction was at arm's length; (ii) the good faith of the parties; and (iii) the difference on the transfer date between the amount paid and the fair market value of what was received. *Peltz v. Hatten*, 279 B.R. 710 (D. Del. 2002); *see also Pension Transfer Corp. v. Beneficiaries Under the Third Amendment to Fruehauf Corp. Retirement Plan (In re Fruehauf Trailer Corp.)*, 444 F.3d 203, 213 (3d Cir. 2006).

3. Distressed Financial Condition

The Code defines solvent as "a financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation." 11 U.S.C. § 101(32). The Debtor's financial condition including solvency (or lack thereof) is typically the subject of expert testimony. Unreasonably small capital is not defined in the Code but has been interpreted by experts to mean capital sufficient to afford qualified managers a reasonable chance of expecting a plausible business strategy in expected market conditions.

C. Transactions Commonly Attacked as Fraudulent Transfers

Several types of transactions are particularly susceptible to fraudulent conveyance attack. These include affiliate guaranties and third party pledges of collateral, intercompany dividends, asset transfers between affiliates and contractual obligations to third parties undertaken for the benefit of affiliates.

1. Guarantees and Third Party Pledges of Collateral

A guarantee is an undertaking by one person to answer for the payment of a debt or for the performance of some obligation of another person who is primarily liable for such payment or performance. Guarantees and third-party pledges of collateral are often attacked in bankruptcy as fraudulent transfers. The execution of the guaranty is a transfer within the meaning of the Code. Reasonably equivalent value for this purpose means consideration which benefits the guarantor. Reliance by the creditor will not suffice. There are three types of corporate guarantees: upstream, downstream, and cross-stream.

a. Upstream Guarantees

An upstream guarantee occurs when a subsidiary guarantees a loan made to its parent corporation. The Code allows a debtor to avoid an upstream guarantee given one year prior to the filing of the bankruptcy petition if the guarantor did not receive adequate consideration (*i.e.*, "reasonably equivalent value") *and* the giving of the guarantee rendered the guarantor "insolvent" or, in certain other ways, adversely affected the financial condition of the guarantor.

b. Cross-Stream Guarantees

A cross-stream guarantee occurs when one corporation guarantees a loan made to another corporation which is owned by the same parent corporation. These guarantees are subject to the same fraudulent conveyance problems as upstream guarantees.

c. Downstream Guarantees

A downstream guarantee occurs when a parent corporation guarantees a loan made to one of its subsidiaries. Generally, these guarantees are not challenged as fraudulent conveyances because of the obvious benefit which the guarantee affords to the parent's investment in the subsidiary. However, where the parent and subsidiary have distinct creditors and the subsidiary is insolvent, the parent company's creditors may attack the guarantee. While a transfer to a wholly-owned solvent subsidiary is often for reasonably equivalent value because the value of the parent's stock interest in the subsidiary may be correspondingly increased, that is never the case when the subsidiary is hopelessly insolvent because the value of those shares is zero both before and after the transfer. *See, e.g., In re Duque Rodriguez*, 77 B.R. 937, 939 (Bankr. S.D. Fla. 1987), *aff'd*, 895 F.2d 725 (11th Cir. 1990); *In re Chase & Sandborn Corp.*, 68 B.R. 530, 533 (Bankr. S.D. Fla. 1986), *aff'd*, 848 F.2d 1196 (11th Cir. 1988); *Osherow v. Nelson Hensley & Consol. Fund Mgmt., L.L.C. (In re Pace)*, 456 B.R. 253, 272 (Bankr. W.D. Tex. 2011); *see also* Robert K. Rasmussen, *Guarantees and Section 548(a)(2) of the Bankruptcy Code*, 52 U. CHI. L. REV. 194, 215-16 & n.69 (1985).

2. Other Transactions

There is no reasonably equivalent value for corporate dividends or distributions as a matter of law because only the payee, not the transferor, receives value. *See Pereira v. Equitable Life Ins. Soc'y (In re Trace Int'l Holdings, Inc.)*, 289 B.R. 548, 560-61 (Bankr. S.D.N.Y. 2003). Recovering a dividend as a constructive fraudulent transfer is easier than proving it was an illegal dividend. Dividends can be in the form of cash or assets. Thus asset transfers to a parent or affiliated corporation are critically analyzed.

D. Managing Risk

There are several ways to minimize the risk of fraudulent conveyance attack.

1. Valuation/Solvency Opinions

A counterparty may wish to obtain a valuation opinion on the asset or a solvency opinion from a third party expert such as an investment banker. In order for a bankruptcy judge to give such an opinion much credibility, the expert opining must not be receiving any compensation based on the outcome of the valuation. Thus, an investment banker receiving a fee based on whether a sales transaction occurs may not be especially helpful in a subsequent court proceeding. Carefully drafted certificates of the chief financial officer are also helpful. Accounting firms are precluded from rendering solvency opinions.

2. Allocation of Purchase Price

As to the risk posed by a transaction involving multiple debtor affiliates, a counterparty should take care to ensure that each debtor affiliate receives fair value for its assets in any transaction. Thus, if a subsidiary's assets are being sold, the payment for such asset should be made to the subsidiary, not to the subsidiary's parent. Obviously, the counterparty cannot control whether a debtor affiliate subsequently transfers assets received to a parent corporation. However, by ensuring that its own transaction with each debtor affiliate was fair from that debtor affiliate's standpoint, the counterparty should be able to insulate itself from a fraudulent conveyance claim. Note: The problem in one debtor affiliate receiving payment for another debtor affiliate's assets stems from the possibility that the various debtor corporations have different creditor bodies and insufficient assets to pay off such creditors. Where a particular debtor affiliate has no creditors or has ample assets to pay such creditors, that debtor affiliate may have an identity of interest with its parent corporation such that there is no fraudulent conveyance risk in making payment directly to the parent corporation. Ample due diligence may allow an acquiror to satisfy itself that a particular debtor affiliate has no creditors or contingent creditors such that the transaction could not be subject to subsequent attack as a fraudulent conveyance.

3. Credit for Value Given

The transferee of a transfer is protected if he or she acted in good faith and gave value to the debtor. Such transferee may retain any property transferred to the extent of the value given in return. A good faith transferee from whom the trustee recovers property also has a lien against the property recovered to secure the lesser of (i) the transferee's cost of improvements to the property made after the transfer, less the amount of any *profits* earned by the transferee from the property and (ii) any increase in value of the property as a result of action by the transferee. 11 U.S.C. § 550(e)(1).

4. Calculating the Benefit

If it is intended that the parent downstream (whether by loan, advance, capital contribution or otherwise) some of the loan proceeds to the subsidiary, then the subsidiary obviously stands to benefit (albeit indirectly) from the guarantee. In that situation, the issue would turn on the sufficiency of the benefit. The amounts should be well documented. Where (i) the subsidiary guarantees the entire amount of the loan to the parent and (ii) it is clear that, at most, only a portion of the loan proceeds will be made available to the subsidiary, a serious question will exist as to the adequacy of the consideration.

5. Limitation of Guaranty

It may be advisable to limit the subsidiary's obligation under the guarantee. For example, the guarantee might limit the subsidiary's liability under the guarantee to the amount of loan proceeds actually downstreamed to it by the parent. Provisions should be included in the guarantee limiting the liability of the subsidiary under the guarantee in such a way as to minimize the risk that the guarantee will render the subsidiary insolvent.

III. PREFERENTIAL TRANSFERS

Section 547 of the Code provides that a transfer of property to an entity that is a creditor of a debtor can be "recovered" if the transfer can be characterized as a payment in satisfaction of such creditor's antecedent debt. Such transfers are termed "preferences." *See* 11 U.S.C. § 547. Section 547 and its accompanying provisions are worded very broadly so that any payment that can be characterized as a payment on account of an antecedent debt can be recovered, even where the transfer was not made directly to the creditor. Thus, transfers are subject to recovery as preferences if the creditor was a direct or indirect transferee or even where the creditor was not a transferee at all, but was "benefited" by the transfer. Any transfer of a debtor's assets occurring in the time period 90 days prior to that debtor's bankruptcy filing is subject to attack under Section 547. Note that if a creditor can be characterized as an "insider" by virtue of its control over the debtor or other relationship with the debtor, the preference period is extended from 90

days prior to bankruptcy to one year before bankruptcy.

A. Elements of Preference

All of the following elements must be present to avoid a transfer as a preference. There must be:

- a transfer
- of property of the debtor (valued in the aggregate at $5,850 or more)
- to or for the benefit of a creditor
- on account of an antecedent debt
- made while the debtor was insolvent (the debtor is rebuttably presumed to be insolvent during the 90 days before a bankruptcy petition is filed, *see* 11 U.S.C. § 547(f))
- within 90 days prior to filing of the petition (or within one year if the transferee was an "insider" as defined in 11 U.S.C. § 101(31))
- which allows the creditor receiving the transfer to receive more than the creditor would receive in a liquidation of the debtor's assets. *See* 11 U.S.C. § 547(b); *In re El Paso Refinery, L.P.*, 178 B.R. 426, 432 (Bankr. W.D. Tex. 1995), *rev'd on other grounds*, 171 F.3d 249 (5th Cir. 1999).

1. "Transfer" Broadly Defined

"Transfer" is defined as "the creation of a lien; the retention of title as a security interest; the foreclosure of a debtor's equity of redemption; or each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or an interest in property." 11 U.S.C. § 101(54). "[T]he definition of 'transfer' under the Bankruptcy Code is comprehensive and includes every conceivable mode of alienating property, whether directly or indirectly, voluntarily or involuntarily." *Cullen Ctr. Bank & Trust v. Hensley (In re Criswell)*, 1997 U.S. App. LEXIS 12784, at *10 (5th Cir. Jan. 9, 1997).

2. Transfer Must "Prefer" Creditors

A transfer is not preferential unless it enables the creditor to receive more than it would have received in a hypothetical Chapter 7 case if the transfer had not occurred. 11 U.S.C. § 547(b)(5). A creditor with a security interest in a "collateral mass" (*e.g.*, inventory or accounts receivable) is subject to preference attack to the extent it improves its position during the 90-day period before the bankruptcy petition is filed. 11 U.S.C. § 547(c)(5).

3. Intercompany Guarantees

"Insiders" who guarantee their company's debts automatically benefit from preferential transfers made by the debtor company to reduce such debts. Every reduction of a guaranteed debt reduces the "insider" guarantor's liability for payment thereon. Thus, an insider may be liable for payments made on guaranteed debts up to one year before the case was commenced. *See Smith v. Tostevin*, 247 F. 102, 103 (2d Cir. 1917).

B. Defenses

Fortunately there are several defenses to a preference attack which allow the risk to be managed.

1. Ordinary Course of Business Transactions

The most important exception to the preference rule shelters transfers made in the ordinary course of business. The debtor may not avoid a transfer that was in payment of a debt incurred by the debtor in the "ordinary course of business" or financial affairs of the debtor and transferee, and such transfer was

- made in the ordinary course of business or financial affairs of the debtor and transferee; or
- made according to ordinary business terms.

See 11 U.S.C. § 547(c)(2); *In re El Paso Refinery, L.P.*, 178 B.R. 426, 432 (Bankr. W.D. Tex. 1995), *rev'd on other grounds*, 171 F.3d 249 (5th Cir. 1999).

The transfer must either comport with the prior dealings between the debtor and transferee or comport with practices common to businesses similarly situated. In determining whether a challenged transfer is "ordinary," courts employ an "objective industry" test. *See Gulf City Seafoods, Inc. v. Ludwig Shrimp Co. (In re Gulf City Seafoods, Inc.)*, 296 F.3d 363 (5th Cir. 2002); *Lawson v. Ford Motor Co. (In re Roblin Indus., Inc.)*, 78 F.3d 30 (2d Cir. 1996); *Fiber Lite Corp. v. Molded Acoustical Prods., Inc. (In re Molded Acoustical Prods., Inc.)*, 18 F.3d 217 (3d Cir. 1994).

2. No Antecedent Debt

There can be no preference without an "antecedent debt." An antecedent debt is incurred before the transfer (*i.e.* payment). Requiring prepayment for delivery of goods or services eliminates the antecedent debt element.

3. Contemporaneous Exchange for New Value

The trustee may not avoid a transfer to the extent it was: (i) intended by the parties to be a substantially contemporaneous exchange for new value given to the

debtor; and (ii) in fact was a substantially contemporaneous exchange. *See* 11 U.S.C. § 547(c)(1); *see also Baker Hughes Oilfield Operations, Inc. v. Cage (In re Ramba, Inc.)*, 416 F.3d 394 (5th Cir. 2005) (finding that dismissal of an involuntary petition was not "new value" within the meaning of Section 547(c)(1)). Requiring cash on delivery is a contemporaneous exchange.

4. Enabling Loans

Also shielded from preference attack are certain transfers that create a security interest similar to a purchase money security interest (defined in UCC § 9.103). The security interest must secure new value that was given to enable the debtor to acquire particular property, and in fact be used to acquire such property. *See* 11 U.S.C. § 547(c)(3).

5. Subsequent New Value

A transfer may be protected from preference attack to the extent the creditor gave new value to the debtor after the transfer. *See* 11 U.S.C. § 547(c)(4). The "subsequent advance" exception allows a creditor to claim a credit against preferential transfers for subsequent advances of "new value" made after a transfer. *See G.H. Leidenheimer Baking Co. v. Sharp (In re SGSM Acquisition Co.)*, 439 F.3d 233 (5th Cir. 2006); *Williams v. Agama Sys., Inc. (In re Micro Innovations Corp.)*, 185 F.3d 329 (5th Cir. 1999).

6. After Acquired Property Security Interests in Inventory/Receivables

Some creditors have "floating" perfected liens in the debtor's inventory and/or receivables and the proceeds therefrom. To the extent such creditors do not improve their net positions in the collateral during the avoidance period, perfected liens on new inventory and/or receivables (and their proceeds) are not avoidable as preferences. 11 U.S.C. § 547(c)(5).

IV. EQUITABLE SUBORDINATION

Section 510(c) of the Code authorizes a court to equitably subordinate all or part of an allowed claim to all or part of another allowed claim for purposes of distribution. Additionally, a court may order that any lien securing such subordinated claim be transferred to the bankruptcy estate. The majority of circuits employ a three-prong test in determining whether a claim should be equitably subordinated:

A. Misconduct

The claimant must have engaged in some type of equitable misconduct. Inequitable conduct directed against the bankrupt or its creditors may be sufficient to warrant equitable subordination of a claim irrespective of whether it was related to the acquisition or assertion of the claim. There are generally three categories of misconduct which may constitute inequitable conduct: (i) fraud, illegality, and breach of fiduciary duties; (ii) claimant's use of the debtor as a mere instrumentality or alter ego; and (iii) undercapitalization. *Summit Coffee Co. v. Herby's Foods, Inc. (In re Herby's Foods, Inc.)*, 2 F.3d 128, 131 (5th Cir. 1993). Capitalization is inadequate if "in the opinion of a skilled financial analyst, it would definitely be insufficient to support a business of the size and nature of the bankrupt in light of the circumstances existing at the time the bankrupt was capitalized." *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 703 (5th Cir. 1977). Capitalization is also inadequate if "at the time when the advances were made, the bankrupt could not have borrowed a similar amount of money from an informed outside source." *Id.* Once it is established that the Debtor was undercapitalized, a showing of additional inequitable conduct may be required. *Summit Coffee Co. v. Herby's Foods, Inc. (In re Herby's Foods, Inc.)*, 2 F.3d 128, 131 (5th Cir. 1993). The majority of cases reviewed require misconduct in addition to undercapitalization. Some courts have held that it is possible to have "no fault subordination." *See, e.g., In re Virtual Network Services Corp.*, 902 F.2d 1246 (7th Cir. 1990); *In re Burden*, 917 F.2d 115 (3d Cir. 1990).

B. Injury to Other Creditors

The misconduct resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant. Claim(s) should only be subordinated to the extent necessary to offset the harm which the bankrupt and its creditors suffered on account of the inequitable misconduct. *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 701 (5th Cir. 1977).

C. Consistent With Code

Equitable subordination of the claim must not be inconsistent with the provisions of the Code. *See Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 699-700 (5th Cir. 1977). This requirement "has been read as a reminder to the bankruptcy court that although it is a court of equity, it is not free to adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the court perceives the result is inequitable." *Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 160 F.3d 982, 990 (3d Cir. 1998) (quoting *U.S. v. Noland*, 517 U.S. 535, 539 (1996)) (internal quotations omitted).

D. Managing Risk

When dealing with affiliates, care should be taken to ensure that intercompany contracts are in line with terms negotiated between third parties and that the creditor does not use its position to improve the likelihood that its claims against the debtor will be paid while others will not. For nonaffiliates the creditor should not become involved in the day-to-day management of the debtor.

V. DEBT RECHARACTERIZATION

It is not uncommon for a parent corporation or major shareholder(s) to advance money to a company. In bankruptcy these loans are often subject to attack. Courts consider various factors in determining whether advances to a corporation constitute a loan or a capital contribution. The test most widely followed is that articulated in *Roth Steel Tube Co. v. Comm'r. of Internal Revenue*, 800 F.2d 625 (6th Cir. 1986); *see also Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972).

A. Theory

The goal of the recharacterization inquiry is deciding whether what the parties called a loan was in reality an equity contribution. Debt recharacterization merely involves the question: "what is the proper characterization in the first instance of an investment"? *Cohen v. KB Mezzanine Fund II, LP (In re Submicron Sys. Corp.)*, 432 F.3d 448, 454 (3d Cir. 2006) (internal quotations and citations omitted). The power to recharacterize debt into equity stems from the bankruptcy court's authority to test the validity of debts, particularly shareholder loans to undercapitalized debtors. *Diasonics, Inc. v. Ingalls*, 121 B.R. 626, 630 (Bankr. N.D. Fla. 1990) (citing *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307 (1939)). *Taylor v. Standard Gas & Electric Co.* created the so-called "Deep Rock" doctrine, under which a shareholder loan will be recharacterized as a capital contribution when either: (1) there is initial undercapitalization or (2) the loans were made when no disinterested lender would have extended credit. *In re N&D Props., Inc.*, 799 F.2d 726, 733 (11th Cir. 1986); *Diasonics, Inc. v. Ingalls*, 121 B.R. 626, 631 (Bankr. N.D. Fla. 1990)); *In re Cold Harbor Assocs., L.P.*, 204 B.R. 904, 915 (Bankr. E.D. Va. 1997) (citing *Pepper v. Litton*, 308 U.S. 295 (1939)). The Circuit courts that have squarely addressed the power to recharacterize debt to equity in bankruptcy (as opposed to the tax context) have uniformly upheld the power. *Sender v. The Bronze Group, Ltd. (In re Hedged-Invs. Assocs., Inc.)*, 380 F.3d 1292, 1298 (10th Cir. 2004); *Bayer Corp. v. Mascotech, Inc. (In re Autostyle Plastics, Inc.)*, 269 F.3d 726, 748 (6th Cir. 2001); *Summit Coffee Co. v. Herby's Foods, Inc. (In re Herby's Foods, Inc.)*, 2 F.3d 128, 133 (5th Cir. 1993); *but see Unsecured Creditors Comms. of Pac. Express, Inc. v. Pioneer Commercial Funding Corp. (In re Pac. Express, Inc.)*, 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986); *In re Pinetree Partners, Ltd.*, 87 B.R. 481, 491 (Bankr. N.D. Ohio 1988). The "focus of the recharacterization inquiry is whether a debt actually exists…." *In re Submicron Sys. Corp.*, 432 F.3d at 454.

B. Test

Though courts have developed numerous factors to consider, "they devolve to an overarching inquiry: the characterization as debt or equity is a court's attempt to discern whether the parties called an instrument one thing when in fact they intended it as something else. That intent may be inferred from what the parties say in their contracts, from what they do through their actions, and from the economic reality of the surrounding circumstances." *In re Submicron Sys. Corp.*, 432 F.3d at 456. Though the courts have articulated a 13-factor analysis, they really are just using inductive reasoning—sometimes called the duck test ("If it quacks like a duck…"). The 13 factors consistently considered by courts are as follows:

- Is the contribution labeled debt?
- Does the contribution have a maturity date, like debt?
- Is the contribution repaid independent of the business' success, like debt?
- Is repayment enforceable with appropriate safeguards, like debt?
- Is the contribution given independent of management control, like debt?
- Does the contribution have the subordination status of general creditors, like debt?
- Did the parties *objectively* intend to create debt?
- Was the debtor securely capitalized, like those who can take on debt?
- Was the contribution given independent of equity interests, like debt?
- Is the contribution primarily given in order to earn interest, like debt?
- Could the contribution have been obtained from outside lenders, like other debt?
- Was the contribution used to fund operations (not grow capital), like debt?
- Did the debtor repay the contribution, or seek postponement if he cannot, like debt?

"Which course a court discerns is typically a commonsense conclusion that the party infusing funds does so as a banker (the party expects to be repaid with interest no matter the borrower's fortunes; therefore, the funds are debt) or as an investor (the funds infused are repaid based on the borrower's fortunes; hence, they are equity). Form is no doubt a factor, but in the end it is no more than an indicator of what the parties actually intended and acted on." *In re Submicron Sys. Corp.*, 432 F.3d at 456.

The court inquires of the "actual" or "true" nature of the transaction, with the primary consideration being "whether the transaction bears the earmarks of an arm's length negotiation. . . . The more such an exchange appears to reflect the characteristics of such an arm's length negotiation, the more likely such a transaction is to be treated as debt." *In re Cold Harbor Assocs., L.P.*, 204 B.R. 904, 915 (Bankr. E.D. Va. 1997).

The factors used to recharacterize debt as equity have been adopted from the factors used outside the bankruptcy context, primarily the tax context. *In re Submicron Sys.*, 432 F.3d at 455 & n.8. The factors identified are not exhaustive and are applied to achieve the overall objective discussed above—determining whether it was truly equity or debt. *In re Cold Harbor*, 204 B.R. at 915.

Courts have identified 13 factors and "consider all the factors and weigh the evidence favoring characterization of the advance as debt or equity, while realizing that the various factors are not of equal significance and that no one factor is controlling." *Stinnett's Pontiac Serv., Inc. v. IRS*, 730 F.2d 634, 638 (11th Cir. 1984) (internal quotations omitted); *accord Lane v. United States (In re Lane)*, 742 F.2d 1311, 1314-15 (11th Cir. 1984). The following list comes from these two cases:

1. <u>The Name Given the Certificate Evidencing the Contribution</u>

- A stock certificate indicates equity, a bond indicates a debenture, and a note indicates debt. *Stinnett's*, 730 F.2d at 638.
- Merely "set[ting] forth the advances to the corporations in the form of notes is not of significant importance in our determination of whether the advances constituted debt or equity." *Lane*, 742 F.2d at 1315.
- "[A]n unsecured note due on demand with no specific maturity date, and no payments is insufficient to evidence a genuine debt." *Stinnett's*, 730 F.2d at 638.
- Documenting the transaction as debt *afterwards* undermines the weight given this factor. *In re Cold Harbor*, 204 B.R. at 916-17 (seven-month delay).

2. <u>The Presence of a Fixed Maturity Date</u>

- "[T]he presence of a definite maturity date and a definite obligation to repay," is a "highly significant feature of a debtor-creditor relationship." *Stinnett's*, 730 F.2d at 638 (internal quotations omitted). In contrast, "the absence of a fixed maturity date is indicative of an equity advance." *Id.* When "no fixed date for repayment existed for any of the advances, . . . [t]his factor . . . strongly indicates that the advances were contribution to capital, and not loans." *Id.; see also Lane*, 742 F.2d at 1316.
- The question under this factor is "how definite were the plans for repayment. If the terms are vague and nonspecific, then the advance takes on the appearance of equity as it is assumed that a non-shareholder bargaining at arm's length would demand specifics and formalities to protect their investment." *In re Cold Harbor*, 204 B.R. at 917.
- The demand feature of a note between companies who share directors and management is a "mirage." *Texas Farm Bureau v. United States*, 725 F.2d 307, 313 (5th Cir. 1984); *accord Tyler v. Tomlinson*, 414 F.2d 844, 848 (5th Cir. 1969).
- If the plan was to demand repayment only "when it was good for [the advancer's] business or the [debtor's] business," this indicates the contributions are equity, not debt. *Lane*, 742 F.2d at 1316.

3. <u>The Source of Payments</u>

- If "repayment is possible only out of corporate earnings, the transaction has the appearance of a contribution of equity capital, but if repayment is not dependent upon earnings, the transaction reflects a loan to the corporation." *Stinnett's*, 730 F.2d at 638 (internal quotations omitted). If selling assets would be inadequate to repay the contribution, the only way to repay it is, by definition, through earnings from operations, which indicates the contribution was a loan. *Id.* at 639.
- The "complete lack of security" is "strong evidence that the transaction was not made at arm's length, and that the advances were capital

contributions instead of loans." *In re Cold Harbor*, 204 B.R. at 918.

- The fact that repayments occurred does not address this factor; instead, even repayment supports recharacterization if it occurred only because the debtor had the cash—which is consistent with the "repayment" being a dividend. *Slappey Drive Indus. Park v. United States*, 561 F.2d 572, 582 (5th Cir.[1] 1977). A "pattern of conduct" involving repayments of this variety "belies any intention to structure their affairs as parties to a debt transaction ordinarily would." *Id*. at 583.

4. The Right to Enforce Payment of Principal and Interest

- "If a fixed obligation to repay the advances exists, the transaction appears to be a loan." *Stinnett's*, 730 F.2d at 639. When the "repayment was within the discretion of the parties and was not conditioned upon the occurrence of certain events," this factor suggests "the advances were contributions to capital and not debt. *Id*.
- Even if the bare right to enforce repayment of the contribution exists, if the advancer takes "none of those customary steps which we would expect a lender to take to guaranty repayment in the event the business failed," such as "fail[ing] to secure advances" or "establish a sinking fund," suggests equity, not debt. *Lane*, 742 F.2d at 1317

Recharacterization is a fact intensive inquiry. *See, e.g.*, *Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972).

C. Conclusion

A thorough understanding of the factors courts consider in determining whether an advance is debt or equity is key. Intercompany transactions should be well documented. Loans should be evidenced by promissory notes which set forth payment terms, interest rates and maturity. Collateralized loans are preferred along with evidence of the company's adequate capitalization.

VI. RECOVERY OF ILLEGAL DIVIDENDS

Many states have enacted statutes that prohibit a corporation's board of directors from declaring a dividend to the corporation's shareholders if the corporation would be insolvent after the distribution. *See, e.g.*, LA. REV. STAT. ANN. § 12:63; MISS. CODE ANN. § 79-4-6.40; N.Y. BUS. CORP. LAW § 510; *see also* DEL. CODE ANN. tit. 8, § 170 (requiring that dividends only be paid from a corporation's surplus, or if there is no surplus, out of the corporation's net profits for the fiscal year for which the dividend is declared or for the preceding fiscal year). Under the Texas Business Organizations Code, a corporation may not make a distribution: "(1) if the corporation would be insolvent after the distribution; or (2) that exceeds the distribution limit." TEX. BUS. ORGS. CODE § 21.303(b). The directors of the corporation who voted for or assented to an illegal dividend are jointly and severally liable to the corporation for the amount of the distribution that exceeds the amount that could have lawfully been paid. TEX. BUS. ORGS. CODE § 21.316(a).

A. Distributions Need not be Formally Declared as Dividends

"Distribution" is defined as "a transfer of property, including cash, or issuance of debt, by a corporation to its shareholders in the form of: (i) a dividend on any class or series of its outstanding shares; (ii) a purchase or redemption, directly or indirectly, or any of its own shares; or (iii) a payment by the corporation in liquidation of all or a portion of its assets." TEX. BUS. ORGS. CODE § 21.002(6)(A). The Texas Supreme Court has stated that a distribution by a corporation to its shareholders may constitute a dividend, even if the board of directors of the corporation did not declare it as such. *See Ramo, Inc. v. English*, 500 S.W.2d 461, 465 (Tex. 1973) ("A distribution of money or property by a corporation to its shareholders may constitute a dividend in law even though not formally designated as such by the board of directors."); *see also TTT Hope, Inc. v. Hill (In re Powell)*, 2008 U.S. Dist. LEXIS 67719, at *18-19 (S.D. Tex. Sept. 2, 2008) ("A corporation need not formally declare a dividend when it sets apart funds for distribution to its shareholders because that has the legal effect of a declared dividend.") (citing *Ramo*).

B. Distributions that Exceed the Distribution Limit

The "distribution limit" referenced in the statute is the "surplus" of the corporation, which is defined as "the amount by which the net assets of a corporation exceed the stated capital of the corporation." TEX. BUS. ORGS. CODE § 21.002(12).

C. Meaning of Insolvency

The Texas Business Organizations Code defines "insolvency" as "the inability of a person to pay the person's debts as they become due in the usual course

[1] Pre-11th Circuit split.

of business or affairs." TEX. BUS. ORGS. CODE § 1.002(39). The statute provides a list of sources of information upon which a determination of insolvency may be based, including: financial statements that present the financial condition of the corporation in accordance with generally accepted accounting principles; financial statements prepared using the method of accounting used to file the corporation's federal income tax return or "using any other accounting practices and principles that are reasonable under the circumstances;" projections, forecasts, or other forward-looking information "relating to the future economic performance, financial condition, or liquidity of the corporation that is reasonable under the circumstances;" "a fair valuation or information from any other method that is reasonable under the circumstances;" or a combination of the foregoing information. TEX. BUS. ORGS. CODE § 21.314(a).

If the distribution was made not more than 120 days after the date of declaration by the board of directors, then the relevant date for determining insolvency is the date the distribution was authorized by the board of directors. TEX. BUS. ORGS. CODE § 21.315(a)(1). If the distribution was made more than 120 days after the date of authorization by the board of directors, then the relevant date for determining insolvency is the date the distribution is made (or the date designated by the board of directors if later than 120 days after the date of authorization). TEX. BUS. ORGS. CODE § 21.315(a)(2).

D. Defenses

A director has several defenses to liability for authorizing an illegal dividend. First, a director is not liable for authorizing an illegal dividend if the director relied in good faith and with ordinary care on the corporation's financial statements or other information deemed acceptable in the statute for use in determining insolvency. TEX. BUS. ORGS. CODE § 21.316(c)(1)(A). The director also is not liable if he or she relied in good faith and with ordinary care on financial statements, reports, or other information prepared or presented by: "(i) one or more officers or employees of the corporation; (ii) a legal counsel, public accountant, investment banker, or other person relating to a matter the director reasonably believes is within the person's professional or expert competence; or (iii) a committee of the board of directors of which the director is not a member." TEX. BUS. ORGS. CODE § 21.316(c)(1)(B). The director is not liable if he or she, acting in good faith and with ordinary care, "considers the assets of the corporation to be valued at least at their book value." TEX. BUS. ORGS. CODE § 21.316(c)(2). The director is also not liable if he or she, in determining whether the corporation made adequate provision for satisfaction of its liabilities, relies in good faith and with ordinary care on financial statements or other information concerning a person who was contractually obligated to satisfy some or all of the corporation's liabilities. TEX. BUS. ORGS. CODE § 21.316(c)(3).

E. Liability of Shareholders

A director who is liable for making an illegal dividend may be entitled to contribution from the shareholders who accepted the distribution. TEX. BUS. ORGS. CODE § 21.318(a). The shareholders must have accepted the dividend knowing that it was prohibited by the statute. *Id.* If the director's contribution action succeeds, a shareholder is only liable for his or her proportional share of the dividend. *Id.*

VII. CONCLUSION

Each of the identified causes of action poses a risk to entities that deal with financially distressed companies. These risks are best managed by becoming and remaining informed about the financial condition of the relevant company and thoroughly documenting transactions with that company in order to minimize subsequent attacks on the transaction.