

## BUSINESS LITIGATION

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*It is generally accepted that by structuring a purchase as an asset purchase rather than a stock transaction, the buyer of a business can shield itself from the seller's liabilities. Not so fast. Purchasers can still be held responsible for the seller's liabilities – or at least embroiled in expensive litigation concerning their liability – under the “fraudulent transfer doctrine.” This article addresses some of the problems associated with fraudulent transfer litigation and offers suggestions to help your clients reduce their risk of such litigation and to fight back against such litigation.*

## The Scourge of Fraudulent Transfer Litigation

### ABOUT THE AUTHORS



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### ABOUT THE COMMITTEE

The Business Litigation Committee consists of members involved in business and commercial litigation including business torts, contract and other commercial disputes, e-commerce, antitrust issues, trade secrets and intellectual property, unfair competition and business defamation and disparagement. The Business Litigation Committee helps connect members involved in these areas around the world through networking and referral opportunities; developing and keeping current in the substantive, strategic and procedural aspects of business litigation; and affords members an international forum for sharing current developments and strategies with colleagues. Among the committee’s planned activities are newsletters, publications, sponsorship of internal CLEs, and Webinars. Learn more about the Committee at [www.iadclaw.org](http://www.iadclaw.org). To contribute a newsletter article, contact:



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It is axiomatic among transactional attorneys that purchasing the assets of another business, as opposed to stock purchase, will immunize the purchasing entity from the liabilities of the seller absent a limited number of exceptions, such as an express agreement to assume the liabilities or a “de facto merger.” See, e.g., *Cont’l Ins. Co. v. Schneider, Inc.*, 873 A.2d 1286, 1291 (Pa. 2005); *Bingham v. Goldberg Marchesano Kohlman Inc.*, 637 A.2d 81, 89-90 (D.C. 1994); *Schumacher v. Richards Shear Co.*, 451 N.E.2d 195, 198 (N.Y. 1983). Some states do not recognize successor liability at all, absent a written agreement to the contrary. See, e.g., Tex. Bus. Orgs. Code Ann. § 10.254 (no successor liability under Texas law absent express assumption of liability).

It likely will come as a surprise to most asset purchasers, therefore, that they could still be on the hook – or, at a minimum, subject to extended and expensive litigation. This end-around traditional successor non-liability law is known as the law of “fraudulent transfer,” and is becoming a favorite of the plaintiffs’ bar. Under most states’ fraudulent transfer laws, the transferee may be found liable even if it purchased the assets with the purest of motives. Moreover, since there is no bright line test for fraudulent transfers, a bona fide purchaser of assets can easily find itself immersed in lengthy litigation with little chance of escaping on summary judgment.

Fraudulent transfer law is not a new concept; it derives from the Statute of 13 Elizabeth, which Parliament enacted in 1571, and has long been a part of state law, as well as federal

bankruptcy law. The original purpose of fraudulent transfer law was straightforward enough, designed to remedy “a practice by which overburdened debtors placed their assets in friendly hands thereby frustrating creditors’ attempts to satisfy their claims against the debtor. After the creditors had abandoned the effort to recover on their claims, the debtor would obtain a reconveyance of the property that had been transferred. Such transactions operated as a fraud against the debtor’s creditors because the debtor’s estate was depleted without exchanging property of similar value from which the creditors’ claims could be satisfied.” *Mellon Bank, N.A. v. Metro Communications, Inc.*, 945 F.2d 635, 644-45 (3d Cir. 1991). Although transfers to insiders or family members remain at the heart of fraudulent transfer law, more modern fraudulent transfer statutes have been applied in a wide variety of contexts, many having nothing to do with parking assets with a confederate.

The Uniform Fraudulent Transfer Act (“UFTA”), which has been adopted by 43 states and the District of Columbia, is the most common non-bankruptcy fraudulent transfer statute. The statute provides that a creditor of the seller of the assets may seek the avoidance of the sale or money damages from the asset purchaser “if the debtor made the transfer or incurred the obligation . . . with actual intent to hinder, delay, or defraud any creditor of the debtor.” On its face, that language would give little pause to purchasers of corporate assets who did so in good faith and in an above-board manner. The problem is that UFTA’s focus is on the *seller*, not the

buyer, so even an innocent buyer may find itself liable for the seller's liabilities if (a) the seller's assets are insufficient to satisfy the liability and (b) the seller is found to have sold with fraudulent intent.

That still wouldn't be problematic if all fraudsters would simply stand up and admit their frauds. Unfortunately, few do, so UFTA sets forth a nonexclusive list of factors – colloquially referred to as “badges of fraud” – that a court may consider in determining whether the seller had “actual intent to defraud:”

- Whether the transfer was to an insider;
- Whether the seller retained possession or control of the property after the transfer;
- Whether the transfer was disclosed or concealed;
- Whether the seller had been sued or threatened with suit before the transfer;
- Whether the sale was of substantially all of the seller's assets;
- Whether the seller “absconded” after the sale;
- Whether the seller removed or concealed assets;
- Whether the value of the consideration received by the seller was reasonably equivalent to the value of the asset sold;
- Whether the seller was insolvent or became insolvent shortly after the assets had been sold;

- Whether the asset sale occurred shortly before or shortly after the seller had incurred a “substantial debt;” and
- Whether the seller transferred the essential assets of the business to a lienor who transferred the assets to an insider of the seller.

Although few corporate sellers of assets “abscond” after an asset sale, the remaining “badges of fraud” can hint of wrongdoing even where none existed. Take, for example, a company engaged in a business with considerable routine litigation that has recently encountered cash flow difficulties. The company decides to sell substantially all of its assets to a reputable buyer for \$100 million – a price negotiated at arm's length that the seller concludes is a good deal for itself and its shareholders. The buyer announces the acquisition in the press, but does not disclose the purchase terms. The seller pays its creditors, winds itself up, and distributes the remaining cash to its shareholders. Months later, one of the seller's vendors, irked that the purchaser will not continue buying on the same sweetheart terms as did the seller, announces that it has a claim against the seller for \$10 million. The seller has wound up its affairs, so the vendor seeks to recover from the buyer.

The fact that the vendor was not even a creditor at the time of the sale is of no moment; UFTA provides that a creditor can bring a fraudulent transfer action “whether the creditor's claim arose before or after the transfer was made.”

Further, the vendor can potentially point to several arguable “badges of fraud.” The sale was of substantially all of the seller’s assets. The seller’s cash flow problems potentially rendered the seller temporarily insolvent. The routine litigation filed against it meant that the seller “had been sued or threatened with suit” sometime before the sale. By claiming that the seller could have held out for a higher offer, the vendor can assert that the sale price was not “reasonably equivalent to the value of the asset sold.” Are these enough to suggest fraud? The courts offer little in the way of guidance on the issue. *See, e.g., Wohlstein v. Aliezer*, 321 S.W.3d 765, 777 (Tex. App. 2010) (“[T]here is no magic number of factors that must exist [although] the presence of several ‘badges’ may support an inference of fraud.”); *In re Stanton*, 457 B.R. 80, 94 (Bankr. D. Nev. 2011) (“[B]adges of fraud are not given equal weight; and sometimes the circumstances indicate they should be given no weight at all. As *Collier* states: ‘Whatever badges of fraud a court uses, no particular badge is necessary, nor is any combination sufficient.’”) (quoting *Collier On Bankruptcy* ¶ 548.04[1][b][ii] (Henry Sommer & Alan Resnick, eds., 16th ed. 2011)). The upshot is that, once an asset purchaser is dragged into the fraudulent transfer morass, it’s hard to get out. Because of the fact-intensive nature of the “intent to defraud” inquiry, courts rarely grant summary judgment in favor of the defendant when multiple “badges of fraud” exist. *See, e.g., Reese Bros., Inc. v. U.S. Postal Svc.*, 905 F.Supp.2d 223, 262 (D.D.C. 2012) (“[T]he applicable legal standard is a multi-factored

test that, unless the evidence is completely one-sided, is not amenable to decision as a matter of law. . . .”); *Andrews v. RBL, LLC*, 2013 WL 2422703, at \*10 (Bankr. S.D. Ala. 2013) (“[C]ourts generally hold that fraudulent transfer issues are inappropriate for summary judgment.”).

Another problem is “hindsight bias,” which “refers to the tendency of individuals with outcome knowledge to overestimate the likelihood that they would have foreseen an event outcome.” *Marianne M. Jennings et al., Causality as an Influence on Hindsight Bias: An Empirical Examination of Judges' Evaluation of Professional Audit Judgment*, 17 J. ACCT. & PUB. POLY 143, at 147 (1998). As reasonable as an asset sale may have seemed to the participants at the time, judges and juries have a troubling tendency to impute bad intent to financial transactions when the adverse consequences of such transactions become known after the fact. Consequently, even though questions of “reasonably equivalent value” are to be determined based on the conditions as they were known at the time, retrospective judgments, informed by current information, are often unduly critical.

There is no sure way that an asset purchaser can completely immunize itself from the possibility of fraudulent transfer litigation. However, if it is feasible to escrow a significant portion of the purchase price for several months after the sale, or to obtain the seller’s agreement not to dissipate the purchase payment so that assets are available to pay *bona fide* creditors, the risk may be reduced.

What can an asset purchaser do to limit its litigation expense if made the target in a fraudulent transfer action? In many cases, the first step is to attack the purported creditor's claim; if the claim is adjudged to be worth little, there will be no wind in the sails of the fraudulent transfer action. The second is to ensure that the court has a full understanding of the circumstances surrounding the asset sale, the benefits of the sale to the seller's creditors, and the reasonableness of the value paid for the assets. Finally, the focus should

remain on the total effect of the transaction on creditors. If the seller was in financial difficulty at the time of the sale, the creditor-plaintiff's lawyer will undoubtedly point to the seller's insolvency or near-insolvency as a "badge of fraud." What the defense lawyer needs to impress upon the court is that the asset sale offered the greatest benefit to the seller's creditors: without the sale of assets, the seller's financial condition may have made payments to creditors far *less* likely.

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