Insolvency Considerations in Commercial Litigation

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Whether as a company's general counsel or as a client's litigation counsel, it may be foreign to your daily practice to think about the law that governs insolvency and the tools of that practice. However, when a client's company discovers a corporate fraud or theft or it finds itself headed into a bet-your-company dispute, it is worth thinking outside the box. This discussion describes how the law defines insolvency, the way the tools of insolvency law work in these unexpected circumstances, and some areas to think about when determining the strategic importance of insolvency considerations.

Introduction

It is nothing new for companies facing insolvency or financial distress regarding creditors to consider bankruptcy and the tools of the Bankruptcy Code and state statutes. It is also typical for such companies to plan and analyze their payments of debt and their payments to equity holders very carefully in light of the potential for payments to be unraveled later under Chapter 5 of the Bankruptcy Code and similar state statutes.

However, the circumstances that should trigger such considerations are not always so straight forward. Frequently, commercial litigators are in the midst of a perfect storm of circumstances that merit consideration of the more sophisticated application of—and consequences of—fraudulent transfer law and insolvency planning. These considerations are not only relevant for tactical use *in* the course of litigation, they are also relevant for addressing potential liability related to the company's change in circumstances that uniquely arise in periods of insolvency.

This discussion explores two circumstances in which commercial litigation *should* be married with considerations of insolvency and fraudulent transfer law, but often is not. This may be because the insolvency implications are not at the fore, or it may be that the litigator does not have sufficient expertise in insolvency litigation and consequences in order to spot the issue.

Specifically, this discussion looks at the following two contexts:

1. A corporate defalcation (e.g., embezzlement or fraudulent financial reporting) discovered by the company and investigated
2. A company facing litigation that could, if successful, shut down the company or cause it to have to wind down

When addressing a theft or a potential judgment—two events that are unforeseen and which can dramatically shift the fortunes of a business—it is important to understand that the implications of these events on the company's solvency may necessitate tactical planning beyond simply handling the primary crisis.

In each circumstance, the certainty of the entity's insolvency is not yet realized, and the company may not even appreciate the legal definition

of solvency, thinking that concept only belongs in a bankruptcy proceeding. Nonetheless, any strategy or approach to the litigation at issue would be remiss if insolvency-related legal issues are not timely explored.

Put simply, a failure to consider consequences of insolvency periods (past, present, or future) could translate into directors and officers facing lawsuits that could have been avoided, business owners facing lawsuits well after they are lulled into believing the worst of the litigation is over, and creditors failing to recognize the potential for recovery from using the lever of an insolvency-related claim.

Insolvency Considerations in Corporate Defalcations

As a certified fraud examiner and trial counsel, my engagements often start with a company's fledgling discovery that a trusted employee (usually a CFO, controller, or other financial professional or C-suite member) has been systematically embezzling, misrepresenting the state of the company's affairs, or otherwise creating confusion around the source of the company's altered or less than steady performance.

In those circumstances, so much needs to be handled well: issues surrounding the employee's termination, bank account and company data access issues, marshalling witness testimony carefully, identifying repositories of stolen funds and/or tracing assets purchased with embezzled funds, forensic accounting issues, alerting fidelity policy carriers, bringing in replacement help to the role of the removed embezzler(s), providing potential criminal referrals, investigating potential co-conspirators and persons with knowledge, and the list goes on.

The scope of the investigation could be a matter of days, months, or even years depending upon the complexity and depth of the defalcation at issue.

Unless the discovery also led to an immediate recognition of the company's insolvency, however, insolvency issues are not usually among the primary or immediate concerns. In the midst of the investigation or pursuit of litigation or resolution against the wrongdoer(s), the investigator and the litigators can help the company become aware of and think through those insolvency issues. This discussion explores a few of those issues.

Misrepresentations and Loan Defaults

If the defalcation was material enough such that creditors, particularly lenders, have been misled and/or financial statements that affect the company's creditors (e.g., borrowing base reports, inventory reports, sales numbers, reserves, profitability) were misstated (unbeknownst to the rest of management), that impact should be evaluated as soon as possible.

A technical loan default or other covenant default may put the company in a precarious situation, where it is unable to pay its debts as they come due (one of the three potential indications of insolvency recognized under the U.S. Bankruptcy Code and most states' statutes[1]).

The very complaint or criminal referral the litigation team prepared to assist the company in pursuing the bad actors may be exhibit A to a creditor's or creditors' notice of default.

Newly Discovered Periods of Insolvency

When the defalcation is fully investigated and corrections are made to the company's financial statements, it may be that prior periods, as restated, contain periods of previously undiscovered balance sheet insolvency. During periods of insolvency, the company's management owes fiduciary duties to *creditors*, including a duty to preserve the assets of the company for the sake of creditors.[2]

During those periods of time, dividends paid to equity holders could be considered constructive fraudulent transfers (transfers during a period of insolvency for which the company did not receive reasonably equivalent value) because, during periods of insolvency, equity holders' interest has negative value.

If in light of the defalcations it later becomes clear that the company may default in paying certain creditors, not only the current default but these prior periods of insolvency may become fertile ground for those creditors to file fraudulent transfer claims to claw back company payments to equity holders in order to put more money in the kitty to pay creditors.

Fraudulent Transfer Claims against the Perpetrator

If the embezzler transferred company funds to himself or entities he controls or owns, creditors or a bankruptcy trustee or receiver may consider bringing claw back actions against the embezzler rather than the sometimes more-difficult-to-prove, fact-intensive fraud or theft claims.

Some schemes are more subtle such that the path to proving intentional misconduct is expensive and time consuming and/or may not come with a means of recovering attorneys' fees.

In such circumstances, the cleaner, more straightforward claim may be a claim for fraudulent transfer.

Section 7 of the Uniform Fraudulent Transfers Act ("UFTA") allows the court to award a creditor "any other relief the circumstances may require," which can sometimes include attorney fees and even punitive damages.

Consider the Insurance

As much as fraudulent transfer law can provide a means for creditor recovery against corporate malfeasants who enriched themselves, it should be noted that there is, practically speaking, no insurance that covers fraudulent transfer claims per se. To be more direct: to win such a fraudulent transfer claim is only valuable if you can collect against the perpetrator.

If the embezzler was a covered director or officer or employee with liability coverage, however, the creditor or creditor representative (bankruptcy trustee, receiver, asset assignee) may have a covered claim if they allege that company directors or officers breached their fiduciary duty when making the fraudulent transfer.

For that reason, when investigating an internal defalcation, if the scope of the fraud or scheme could eventually prove to have damaged company finances to the point of insolvency, the company's governance may also become a target of a director and officer liability suit on the theory that management breached its duty of care in allowing or not preventing such transfers to wrongdoers.

These considerations are important to the strategic approach to recovery and for tactical considerations of all constituents: management, creditors, other operating fiduciaries, and the litigators that assist them.

Squash Your Company Litigation

The company has vowed to fight the suit to the death, and it is perfectly capable of paying for its defense. The company's defense counsel assesses the risk of losing the $20 million lawsuit at 60 percent. It is a tough case, but everyone is committed to winning.

Whether the litigator knows it or not, the potential liability assessment may have everything to do with a later determination of insolvency. And the insolvency considerations should not start at the conclusion of the lawsuit, but immediately. Counsel may or may not have a good idea of what the impact of losing that lawsuit may be, but the impact on the company matters not only on the courthouse steps, but on day one of the litigation.

The U.S. Bankruptcy Code's assessment of insolvency, and parallel state statutes, includes not only assets and liabilities recorded on the organization's books, but also the value of *contingent* liabilities.

Just the fact of the lawsuit being filed and assessed at having a greater than 50/50 chance of resulting in that hypothetical $20 million damage amount means that a court in the future may deem the company to have been insolvent at the point back when the $20 million lawsuit was filed. Counsel may be defending a company that a court later will say was insolvent the whole time the defense was ongoing.

A more realistic scenario is that on day one of the lawsuit, management is confident (and so is counsel) in their defense, but the case gets worse as more facts come to light in the discovery process. For example, six months into the case, the company may have to consider the possibility of a judgment award; but, of course, for the last six months it has not been operating as if that judgment was a potential reality.

In the meantime, for the whole pendency of the case, the company was, from a bankruptcy law perspective, *insolvent*. So, all its payments to equity holders, all its payments to creditors that were in some way unusual (in timing or amount), and any transaction it has entered into during the pendency of the case may be walked back by fraudulent transfer claims should the company lose the suit.

The time the company should be concerned about the consequences of losing the suit is the moment the suit is received. The company directors should be concerned not only for the sake of aggressively defending the claims, but they also should consider company affairs post-filing through the lens of potential insolvency-related legal issues.

Important issues to consider include the following:

- How the company will be funded
- How investments will be made in the company during the pendency of the lawsuit

Those issues are examined in the next sections of this discussion.

Panic Distributions

The instinct of owners, particularly of closely held companies, when a large, potential company-squashing suit is filed may be to distribute the money and run. After all, the shareholders or owners see a currently healthy business, and they want to be sure that they do not leave that value there just to be taken by the purveyors of the lawsuit.

The commercial litigator defending the suit is likely to not even ask about, let alone advise, on the company's distributions during the pendency of the case, as that may seem it has nothing to do with the case.

But equity distributions made at a time when the business would be balance sheet insolvent if the expected liability from the lawsuit were treated as a current liability may well be a good way to buy two lawsuits for the price of one. If a judgment is obtained against the company, the holder of that judgment will then seek to collect.

If the company cannot pay the judgment, one avenue available to the judgment creditors is to sue the equity holders (and anyone else who arguably received company assets for less than reasonably equivalent value) for having received constructively fraudulent transfers from the company.

All that judgment creditor will have to prove is that the company was insolvent at the time distributions were made to equity holders; dividends paid when a company is considered insolvent are routinely the subject of claw back or fraudulent transfer claims. This is because the value of the equity holders' interest in the company is eliminated when the company is considered insolvent.

Make It a Loan

A company's equity holders looking down the barrel of a large potential judgment may struggle with the decision to infuse more invested funds into the company at a time when the lawsuit may result in a judgment entitling the holder to all the remaining unencumbered assets of the company. They may be stuck having to make that investment to stay in business (or to pay their counsel's legal bills).

As the company may still prevail in the lawsuit, leadership may be hesitant to pull the bankruptcy cord, but again, if equity investment is infused, it may very well become the subject of a claw back or fraudulent transfer action by the judgment creditor later.

The solution that company owners land on frequently when there are concerns that they will not have much equity interest left if or when the a judgment is awarded is to make a loan to the company. The owners effectively put themselves in line with other creditors of the company.

While there is nothing wrong with making a loan, if it is not a really a loan—it does not look, quack, and act like a loan—a court in a later fraudulent transfer suit may not be fooled. A creditor can argue that the loan should be recharacterized as an equity investment if it does not have the indicia of debt.

Typical factors that courts look to in deciding whether the debt is really a debt or an equity investment in disguise are as follows:

1. Names given to the instruments, if any, evidencing the indebtedness
2. Presence or absence of a fixed maturity date and a schedule of payments

3. No fixed rate of interest or interest payments
4. Whether repayment depended on success of the business
5. Inadequacy of the company's capitalization
6. Identity of interests between creditor and stockholder
7. Security, if any, for the advances
8. Ability to obtain financing from outside lending institutions (on the theory that if no one else would lend to the company, the stockholder probably did not)
9. The extent to which the advances were used to acquire capital assets (if the money was just for day to day operations, it is more likely debt, whereas increasing the assets of the business leans in favor of treating the inflow as capital investment)
10. Whether there is a sinking fund (if the company has to put aside money periodically to ultimately pay off the debt, it is more likely debt)
11. Whether voting rights were changed or given with the investment of funds[3]

If a court or jury finds that the debt should be treated as equity and recharacterized as such based on these factors, any payment to equity holders during the period in which the company is insolvent may be clawed back as a fraudulent transfer.

A Real Life Example[4]

Let's consider a real-life small business example: Widget Installer Co. ("Widget") installs widget-parts in industrial plants. One of its widget suppliers sues for $800,000 in allegedly unpaid invoices. Widget hires trial counsel to defend the suit.

Management knows the suit is unfounded; after all, the company pays all of its bills and the negotiated terms allowed for discounts on the widgets it ordered. But a recent data-loss disaster destroyed the company's accounting records and the documents showing the agreed discounts promised.

Counsel is concerned that the testimony of management without more evidence will not win the day, but then again, it may.

Widget does not carry a lot of assets on hand. Widget is primarily an installer and service provider. As a result, the Widget assets at the time the suit is filed are limited to the following:

1. Leftover inventory of widget parts with an approximate liquidation value of $180,000
2. A certificate of deposit of approximately $100,000 in value that is currently securing a bond required by a contract that Widget has in place for a client
3. An additional $150,000 of receivables

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In terms of liabilities, (1) the company has a promissory note due to its bank of $200,000 not yet matured and (2) the company's largest shareholder has a loan to the company committing Widget to repay the debt owed directly to him. However, there is no documentation, no stated interest rate or definite repayment date. The amount of this debt fluctuates, but it hovers around $100,000.

If the supplier is awarded a judgment for $800,000, there is no doubt that the company cannot pay the judgment—at least not without some form of longer-term payment terms.

The business is profitable and the largest, controlling shareholder regularly receives dividend payments. He wants to continue making investments in the business and receiving dividend payments during the pendency of the suit.

Given a strong likelihood that a judgment in excess of the company's net assets will be entered, Widget was insolvent the moment the suit was filed from a fraudulent transfer analysis perspective. The contingent liability was likely to be greater than the net assets. Therefore, any dividend payment made to the controlling shareholder or to other shareholders may very well be the subject of a fraudulent transfer or preference suit by the judgment creditor when it cannot collect from the company.

The controlling shareholder could still invest money through a loan mechanism. However, the loan agreement that exists is highly susceptible to being recharacterized as equity because it does not have the definite terms, form, or strictures of debt.

"The law generally expects the management of a company in the vicinity of insolvency to prioritize preservation of the assets for all creditors."

Even if the controlling shareholder papers a loan to the company with all the definite terms, a judgment creditor may seek to recharacterize that loan as an equity infusion. If that occurs, a court will be able to look behind the paper to see whether any other lender would have made such loans and whether the loan was not for purchasing capital assets, like a new truck that the shareholder may drive off into the sunset with if a judgment is awarded.

Although it may be difficult for a closely held company's largest shareholder to understand how he or she cannot simply run the business as usual until the lawsuit is resolved, in most jurisdictions, when the company goes into the "zone of insolvency"—generally a position where the company owes more than it owns or when debts exceed assets—the duties of the company's officers and directors are to the creditors of the company and, specifically, to preserve corporate assets for the creditors' benefit.

The law generally expects the management of a company in the vicinity of insolvency to prioritize preservation of the assets for all creditors.

As a general matter, any monies that leave the company may be the subject of fraudulent transfer or preference claims if they do not provide equal value to the company. Such claims can be made against the recipient of those transfers for value received that did not provide the company/debtor with equal value.

Specifically, loan repayments to equity owners and any direct benefits to company owners are viewed skeptically by courts. If those expenditures cannot be tied to value received by the company, they may be pursued by the judgment creditor.

In effect, Widget is being run for the benefit of the supplier that is suing it, an important point for the owners and management of the company to understand when gauging how, what, and whether to re-invest in the company and when planning how to manage the defense of the lawsuit.

Conclusion

The subtleties and factual considerations surrounding fraudulent transfer and preference laws; fiduciary duties shifting during periods of insolvency; and corporate representations to lenders, trade creditors, and other third parties require careful, skillful, and strategic thought and planning when a company is contemplating bankruptcy options and when unexpected or uncontrolled circumstances arise.

It is when businesses and their constituents are *not* thinking about bankruptcy, but experiencing unexpected potential or yet-unquantified losses, that these issues may go unnoticed and unevaluated. Having litigators with experience in the insolvency arena can be invaluable in these contexts.

Notes:

1. Insolvency is defined in the Bankruptcy Code and in many states' laws as (a) not being able to pay debts as they come due, (b) being undercapitalized, or (c) balance sheet insolvency (the test for which includes reasonably certain contingent liabilities as well as booked liabilities). *See e.g.*, Peltz v. Hatten, 279 B.R. 710, 742 (D. Del. 2002), *aff'd sub nom*. In re USN Commc'ns, Inc., 60 F. App'x 401 (3d Cir. 2003) ("To succeed on his fraudulent transfer claim . . . the Liquidating Trustee must also prove, by a preponderance of the evidence, that USN was either rendered insolvent by the CT Tel acquisition or insolvent as of the Closing date of February 20, 1998, under one or more of the three insolvency tests set forth in 11 U.S.C. § 548(a)(1)(B)(ii)—the balance sheet test, the unreasonably small capital test, or the ability to pay debts as they come due test.").
2. *See, e.g.*, In re Scott Acquisition Corp., 344 B.R. 283, 288 (Bankr. D. Del. 2006). (Under Delaware law, creditors of an insolvent corporation are owed fiduciary duties.)
3. Bayer Corp. v. MascoTech, Inc. (In re AutoStyle Plastics, Inc.), 269 F.3d 726, 747-50 (6th Cir. 2001); Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.), 432 F.3d 448, 455 n.8 (3d Cir. 2006).
4. The names have been changed to maintain anonymity.

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