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Creditor Strategies to Combat Insider Transactions

By John C. Kilgannon*

In this article, the author reviews the insider transactions that were challenged by the trustee in the Senior Care Centers *bankruptcy case, examines the benefits and perils of an involuntary bankruptcy filing against a company as a means to unwind insider transactions, and explores causes of action that may be asserted in a bankruptcy proceeding.*

A lawsuit recently filed on behalf of unsecured creditors in the *Senior Care Centers*[1] bankruptcy serves as an important reminder of the various remedies that may be employed to attack insider transactions designed to defraud creditors. The complaint filed by the unsecured creditors trustee alleges that the *Senior Care* debtors, who were among the largest providers of skilled nursing services in the country, funneled millions of dollars to related companies prior to their bankruptcy filing. The trustee contends that these funds were drained through a series of improper, self-dealing transactions among commonly owned companies with the objective of thwarting the claims of "legitimate, arm's length creditors."

THE SENIOR CARE CORPORATE STRUCTURE

The *Senior Care* debtors operated skilled nursing facilities (often referred to as "SNFs") through a network of commonly owned entities. The Complaint alleges that the owners of those companies created a corporate structure to funnel funds away from the SNFs into the coffers of related, but separate and distinct, legal entities. Those funds were ultimately upstreamed to ownership beyond the reach of creditors.

The critical component of the Senior Care ownership structure was the creation of holding companies to serve as landlords for the SNFs. The common owners of the SNFs and the landlords structured the lease terms that were well above market. Many of the SNFs were paying excessive rent, or what the trustee characterized as "disguised dividends," even though they were losing money.

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[1] U.S. Bankruptcy Court for the Northern District of Texas (Dallas Division), Case No. 18-33967.

The funds from inflated rents ultimately landed in the accounts of ownership free and clear of claims of creditors. The toll imposed on the debtors' balance sheet by the above market lease payments, unwarranted lease buy downs and debt fueled expansion, precipitated their bankruptcy filing.

POTENTIAL REMEDIES

The litigation commenced by the *Senior Care* Trustee serves as an important reminder that creditors have a number of weapons at their disposal to attack the type of insider transactions complained of in that case. To be sure, there are no easy solutions for creditors who find themselves with a claim against an empty shell. However, when armed with information, diligence and perseverance, creditors can often level the playing field by employing aggressive strategies including those discussed below.[2]

Forbearance Agreements

Creditors can demand that a defaulting company enter into a forbearance agreement or repayment plan providing additional protections to enhance recovery. Such agreements enable creditors to strengthen their position while affording the debtor an opportunity to cure outstanding indebtedness.

Post-Judgment Discovery

Entering a judgment against a defaulting company may prove to be a pyrrhic victory. A company that has divested its cash and other assets in the manner alleged in *Senior Care* will be "judgment proof" or immune from garnishment or execution against its assets. The judgment, however, is often a crucial first step to recovery. Indeed, most states authorize judgment creditors to conduct discovery in aid of execution to access critical information and documents that were not otherwise available during litigation on the merits. Judgment creditors may use this process to discover information on the debtor's corporate structure, assets and liabilities and transfers of funds to related entities. This information may serve as a vital roadmap to recovery against related companies and/or individual owners.

Alter Ego/Piercing the Corporate Veil

In limited circumstances, a creditor may recover against related or commonly owned companies and/or individual owners. This strategy allows creditors to "follow the money" by asserting claims directly against those entities or

[2] This article highlights some remedies and strategies and is not intended to be an exhaustive list. The requirements to establish various claims or causes of action may vary depending on the jurisdiction and applicable law.

individuals who received funds from an insolvent debtor. Recovering on such alter ego and veil piercing claims is challenging; creditors must overcome strong legal presumptions favoring corporate separateness. Close attention must be paid to what state law applies as standards in some states are easier than others.

It is a fundamental principle of American corporate law that (i) companies are separate and distinct legal entities, and (ii) shareholders and owners cannot be held personally liable for the debts of the company. However, in exceptional circumstances, courts will "disregard" the corporate entity and hold related entities and/or owners liable for the debtor's obligation.

A parent and its subsidiary are considered alter-egos "when 'the separate corporate identities . . . are a fiction and . . . the subsidiary is, in fact, being operated as a department of the parent.' Creditors must establish that the companies operated as a single economic unit; and (ii) the presence of an overall element of injustice or unfairness."[3]

Piercing the corporate veil strategies may also be employed to hold individual owners liable. This typically requires a showing that there was no real separation between the company and its owners. A lack of separation may be established when the owner uses company funds to pay personal debts, fails to follow corporate formalities or commingles personal and corporate assets. Failure to adequately capitalize the company also supports piercing the corporate veil.[4]

Director's Breach of Fiduciary Duty to Creditors of Insolvent Companies

A debtor's insolvency may also vest creditors with derivative claims for breach of fiduciary duty. When the company crosses the threshold of insolvency, in

[3] *In re Autobacs Strauss, Inc.*, 473 B.R. 525, 554 (Bankr. D. Del. 2012)(applying Delaware law). Factors considered in determining whether the debtor and related companies were operating as a single economic unit include whether: (a) the debtor is undercapitalized; (b) the debtor was insolvent at the relevant time; (c) the companies failed to observe corporate formalities; (d) the debtor did not pay dividends to the parent; (e) there was a siphoning of the debtor's funds by the dominant stockholder; (f) the absence of corporate records; and (g) the debtor is merely a façade for the operations of the dominant stockholder or stockholders. The showing of injustice or unfairness need not rise to the level of fraud or sham, but rather something that is akin to fraud or sham. *Id.*

[4] The factors considered in determining whether to pierce the corporate veil and hold an individual owner liable include whether: (1) the company was adequately capitalized for the undertaking; (2) the company was solvent; (3) corporate formalities were observed; (4) the controlling shareholder siphoned company funds; or (5) in general, the company simply functioned as a facade for the controlling shareholder. Some courts will also require proof of fraud to pierce the corporate veil. *Sprint Nextel Corp. v. iPCS, Inc.*, (Del.Ch. July 14, 2008) (applying Delaware law).

most states the duties owed to the entity by the board of directors are deemed to pass to its creditors. At that point creditors are, in essence, the company's owners. In other words, the interests of creditors must be taken into account in the decision making process as creditors become "risk bearers" whose interests are affected by management's business decisions. Litigation against directors is often complex and challenging as the decisions by a company's board of directors are granted significant deference under the business judgment rule governing director conduct.

INVOLUNTARY BANKRUPTCY FILING

Next, this article addresses the involuntary bankruptcy option and potential causes of action that may be pursued in the bankruptcy proceeding as a vehicle to avoid and recover inter-company transfers.

The U.S. Bankruptcy Code authorizes creditors to force an insolvent company into bankruptcy if certain conditions are satisfied. Involuntary petitions are often viewed as a last resort because the potential penalties for improper filings are significant.

Despite these risks, involuntary bankruptcy filings offer creditors numerous benefits.

First, the bankruptcy process is predicated on transparency and full disclosure. A debtor is required to open its books and records and may be subject to extensive discovery. Access to financial information and transaction history is particularly important where the debtor is a private, closely held entity. Information on such entities is not readily available to creditors outside of bankruptcy and often serves as the critical foundation to unwind insider transactions.

Second, an involuntary bankruptcy filing enables creditors to monitor a debtor's ongoing operations. The close monitoring of the case by creditors and the Office of the United States Trustee limits the likelihood of ongoing fraud.

Lastly, the Bankruptcy Code includes several provisions providing for the avoidance and recovery of improper transfers made prior to the bankruptcy. In short, an involuntary bankruptcy can be a useful tool to level the playing field and ensure fair treatment among all creditors.

Before pursuing an involuntary bankruptcy, creditors must conduct a comprehensive analysis of the costs and benefits of this option. A full investigation of the requirements for involuntary bankruptcy filings must be conducted prior to the filing and all petitioning creditors should be cognizant of the process of filing and litigating an involuntary petition as well as the penalties that may be assessed if the petition is dismissed as improper.

FRAUDULENT TRANSFER ACTION

If an order for relief is entered, and the company remains in bankruptcy, several causes of action may be pursued to attack insider transactions.[5] First, a pre-bankruptcy transfer made by a debtor may be avoided and recovered as a fraudulent transfer.[6] Importantly, the fraudulent transfer provisions empower the trustee or creditor representative to trace the funds to the ultimate recipient. The resulting effect of avoidance is that the transfer recipient is compelled to return the funds to the bankruptcy estate.

There are two types of fraudulent transfers. The first, which requires a showing of actual fraud, arises where the debtor knowingly and intentionally transferred assets to hinder, delay or defraud its creditor. The second does not require any proof of intent but rather only requires proof that the transferor received less than reasonably equivalent value and was either insolvent at the time of the transfer or rendered insolvent as a result of such transfer. Above market lease payments made by a debtor while insolvent, as alleged in the *Senior Care* bankruptcy litigation, is an example of a transaction that may be avoidable as constructively fraudulent.[7]

PREFERENCE ACTION

A second powerful weapon to recover funds from a debtor's related entities is the preference action.[8] Subject to certain defenses, including for transfers made in the ordinary course of business, transfers made within 90 days of the bankruptcy filing (or longer if the recipient is an "insider"[9] of the debtor) may be avoided and recovered if certain requirements are met. Among other things, the bankruptcy court will examine whether the (i) debtor was insolvent at the time of the transfer, and (ii) transfer effectively provided the recipient an advantage over other creditors.

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[5] Litigation against debtors and/or their related entities is not limited to fraudulent transfer and preference actions; however, these two causes of action tend to be the most prominent.

[6] 11 U.S.C. § 548.

[7] It should be noted that fraudulent transfer actions may also be pursued outside of bankruptcy by individual creditors as most states have adopted fraudulent transfer statutes similar to those provisions in the Bankruptcy Code.

[8] 11 U.S.C. § 547.

[9] An "insider" for purposes of the one year lookback may include "directors, officers and persons in control" of the SNF. This definition has been expanded to include "non-statutory insiders" which may include entities that engaged in transactions with the SNF that were not at "arm's length."

Like fraudulent transfer actions, the proceeds of preference claims will be distributed first to the administrative costs of the bankruptcy, next to priority claims and then equitably among unsecured creditors.