

2nd Circuit affirms bankruptcy court decision finding actual fraudulent transfer and breach of fiduciary duty

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The 2nd U.S. Circuit Court of Appeals decided *In re TransCare Corp.*, No. 21-2547; 21-2576, affirming rulings from the United States District and Bankruptcy Courts for the Southern District of New York, which found that Lynn Tilton — the sole director and indirect owner of TransCare Corp. (the Debtor) — breached her fiduciary duties to the Debtor and caused other entities she directly and indirectly owned and controlled to engage in an actual fraudulent transfer of the Debtor's assets.

In reaching its decision, the 2nd Circuit joined the 4th, 5th, 8th, and 9th Circuits in holding that a finding of fraudulent intent for purposes of a fraudulent transfer is reviewed for clear error — not *de novo*.

Background

The Debtor provided ambulance and paratransit services to hospitals and municipalities in the mid-Atlantic region. Lynn Tilton was a private equity investor and sole director of the Debtor. Tilton indirectly owned approximately 61% of the Debtor, Credit Suisse owned or managed approximately 26% of the Debtor, and various other investors owned the remainder. As the Debtor's sole director, Tilton maintained ultimate control over all of the Debtor's significant financial and operational decisions.

The 2nd Circuit joined the 4th, 5th, 8th, and 9th Circuits in holding that a finding of fraudulent intent for purposes of a fraudulent transfer is reviewed for clear error — not de novo.

The Debtor had two separate lines of credit: (1) an asset-backed loan; and (2) a term loan, including with Credit Suisse. Patriarch Partners Agency Services, LLC (PPAS) — a company that Tilton controlled as the sole manager — was the administrative agent on behalf of all the term loan lenders (including Credit Suisse).

By the end of 2014, the Debtor began to experience financial distress that affected its ability to continue operating. Throughout 2015, the Debtor received several offers from other ambulance

companies to acquire certain of the Debtor's assets, but Tilton did not pursue any of these opportunities. To the contrary, she prohibited her employees from speaking to potential buyers. Indeed, when the Debtor's Chief Executive Officer informed Tilton about an offer, he "was called to Lynn Tilton's office, ...and told [him], Don't ever [expletive] sell one of my companies."

The "Tilton Plan"

After further discussions to reorganize the business failed to produce a solution, Tilton came up with what the 2nd Circuit called the "Tilton Plan." The plan entailed:

Splitting the Debtor into two entities, referred to as "OldCo" and "NewCo."

PPAS (Tilton's entity, acting as the agent for the term loan lenders) would foreclose on the term loan lenders' priority collateral, which would then be transferred to NewCo.

NewCo would operate the most profitable divisions of the Debtor as a going concern.

The remainder of the Debtor's assets (*i.e.*, OldCo) would wind down and then file for bankruptcy.

To fund the Debtor while the Tilton Plan was being implemented, Tilton's personal investment fund, Ark II CLO 2001-1, Ltd. (Ark II), extended a \$6.5 million loan to the Debtor that was secured by blanket liens on all of the Debtor's assets. One issue stood in the way: Credit Suisse (as one of the term loan lenders) held a lien senior in priority to the Ark II lien. Accordingly, Tilton subordinated Credit Suisse's lien by having PPAS (as the agent for the term loan lenders) execute an intercreditor agreement granting Ark II payment priority over the term loan lenders, including Credit Suisse — all without Credit Suisse's knowledge or consent.

On Feb. 24, 2016, the Tilton Plan was "put into motion" and the Debtor filed for Chapter 7.

The Tilton Plan fell apart

The Tilton Plan began to encounter obstacles immediately.

First, after Salvatore LaMonica was appointed the Chapter 7 trustee for the Debtor's estate, a PPAS representative informed the trustee that PPAS had foreclosed on all of the Debtor's physical assets,

including ambulances that were still on the road. The Debtor's estate, however, still owned the Certificates of Need that were required to operate the ambulances now owned by NewCo.

Second, the Debtor was unable to meet its payroll obligations and the trustee made clear that he would not operate the Debtor's business unless he could pay employees.

Finally, when the trustee visited the Debtor's corporate headquarters, he found the president of NewCo attempting to take possession of a computer server that NewCo needed to operate. The trustee refused to surrender the server because it contained the Debtor's books and records.

Shortly thereafter, "Tilton concluded that [NewCo] was a lost cause" and instructed the company to cease all operations. On March 10, PPAS and NewCo transferred the foreclosed collateral back to the Debtor's estate, which the trustee liquidated for the benefit of the Debtor's estate.

Procedural history

In February 2018, the trustee initiated proceedings against Tilton and her companies in bankruptcy court. The trustee asserted, among other claims, an actual fraudulent conveyance claim against PPAS and NewCo, and a breach of fiduciary duty claim against Tilton.

After a six-day bench trial in August 2020, Judge Stuart Bernstein of the bankruptcy court issued a 100-page decision in which he set forth the basis for his conclusion that PPAS and NewCo had engaged in an actual fraudulent conveyance, resulting in damages to the Debtor's estate totaling \$39.2 million, and his recommendation to the district court that it find that Tilton violated her fiduciary duties of loyalty and good faith, resulting in damages to the Debtor's estate of \$39.2 million.

In September 2021, Judge Lewis Kaplan of the district court issued an opinion that (1) affirmed the bankruptcy court's liability determination as to the fraudulent conveyance claim against PPAS and NewCo, and (2) adopted the bankruptcy court's recommendation that Tilton be found liable for breach of fiduciary duty.

The 2nd Circuit's decision

Fiduciary duty claim

As a gating issue, the 2nd Circuit found that Delaware law applied to the breach of fiduciary duty claim against Tilton because the Debtor was incorporated in Delaware. The court then observed that Delaware's "entire fairness" standard applied because the Tilton Plan involved a controlling shareholder engaging in a self-dealing transaction without approval by the company's independent board. Under this standard, Tilton needed to demonstrate that the transactions at issue were the product of both "fair dealing and fair price." The court found neither element was satisfied.

The 2nd Circuit recognized that fair dealing typically requires procedural protections such as appointing an independent special committee to assess the transaction or obtaining the consent of

disinterested stockholders. The 2nd Circuit agreed with the courts below that "[t]here was nothing fair about the process through which Tilton effectuated the foreclosure and sale of the Subject Collateral to [NewCo]." Further, there was no evidence of true arms-length bargaining designed to protect the interests of the Debtor or its minority shareholders.

As to fair price, the 2nd Circuit recognized that the price offered must be "the highest value reasonably available under the circumstances." The court further noted that the valuation could be based on value on a going concern basis or a liquidation basis. If liquidation in bankruptcy was not clearly imminent on the transfer date, then going concern valuation is the appropriate methodology.

The 2nd Circuit acknowledged that a transferor rarely admits her own fraudulent intent. Thus, courts look to numerous "badges of fraud" to ascertain an intent to hinder, delay, or defraud.

Here, Tilton did not use either valuation methodologies. Instead, she relied on the "book value" to determine the value of the assets that were transferred. The 2nd Circuit rejected this methodology, finding that book value tends to undervalue a business as a going concern because it does not fully account for intangible value attributable to the operations.

Tilton further argued that the district court erred by comparing the sale price of the collateral to the going concern value, instead of the liquidation value. The court rejected this contention as well, holding that it was a factual issue and that the district court did not clearly err in using the going concern value.

Fraudulent conveyance claim

The 2nd Circuit observed that a bankruptcy trustee may recover fraudulent transfers made with actual intent to hinder, delay, or defraud creditors. The key question was whether the intent to defraud element was satisfied.

The 2nd Circuit acknowledged that a transferor rarely admits her own fraudulent intent. Thus, courts look to numerous "badges of fraud" to ascertain an intent to hinder, delay, or defraud. These badges include:

- (1) the lack or inadequacy of consideration;
- (2) the family, friendship, or close associate relationship between the parties;
- (3) the retention of possession, benefit or use of the property in question;
- (4) the financial condition of the party sought to be charged both before and after the transaction in question;
- (5) the existence or cumulative effect of a pattern or series of transactions or course of conduct after the incurring of debt,

onset of financial difficulties, or pendency or threat of suits by creditors; and

- (6) the general chronology of the events and transactions under inquiry.

Fraudulent intent can also be inferred from the secrecy, haste, or unusualness of the transaction or the concealment of facts and false pretenses by the transferor.

The 2nd Circuit agreed with the bankruptcy court that “virtually all of the badges of fraud identified [in the case law] are present in this case[,] providing strong circumstantial evidence of Tilton’s fraudulent intent.”

The court also addressed the standard of review for fraudulent intent. Tilton argued the court should apply a *de novo* standard of review — the least deferential standard. The 2nd Circuit disagreed and held that a clearly erroneous standard applies because a finding of fraudulent intent is based on a finding of fact. The 2nd Circuit’s holding that a finding of fraudulent intent is reviewed

for clear error, rather than being reviewed *de novo*, joined decisions from the 4th, 5th, 8th, and 9th Circuits.

Applying the clear error standard of review, the 2nd Circuit easily concluded that Tilton’s evidence of good faith was too weak to reverse the bankruptcy court’s determination that she acted with fraudulent intent. As a result, the 2nd Circuit affirmed the lower courts’ decisions.

Conclusion

TransCare teaches that courts reviewing fraudulent transfer decisions will likely apply a deferential “clearly erroneous” standard of review to the lower court’s decision. The decision also provides guidance as to the “badges of fraud” that courts look to in deciding whether intent to make an actual fraudulent transfer exists.

The writers are regular, joint contributing columnists on bankruptcy law for Reuters Legal News and Westlaw Today.

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