

## Hidden Costs in Bargain Acquisitions of Businesses: Exposure to Fraudulent Transfer Claims

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As the pandemic-induced recession continues, there will be increasing opportunities for investors to acquire failing businesses at bargain prices. Companies with sound business models that were until recently profitable may now be faced with no better option than to sell their assets for as much as the open market will pay. Buyers of these failing companies will likely have the power to strike favorable deals for amounts that sellers would have summarily rejected six months ago. However, buyers should be aware of potentially hidden costs associated with purchasing companies on the cheap, including the potential exposure to the seller's creditors for fraudulent transfer claims.

When owners of failing businesses decide to sell, a primary goal is often to garner enough money to pay debts for which they have signed personal guarantees or for which they have granted mortgages on their residences or other properties to secure repayment. And of course, buyers of businesses desire to acquire assets free of all liens and encumbrances. Unsecured creditors — such as landlords, unsecured lenders, trade creditors, or plaintiffs in pending or threatened lawsuits — often are not paid substantial amounts in the belief that they have no recourse except against a defunct business. However, creditors of a failing business sold below fair value may be able to successfully sue the buyer of the business for engaging in a fraudulent transfer of the selling company's assets.

### Fraudulent Transfer Law

To prove a fraudulent transfer claim, a disgruntled creditor does not need to prove actual intent to defraud. Rather, a creditor need only establish constructive fraud, which depends on proof that the seller did not receive "reasonably equivalent value" for its assets and was insolvent at the time of transfer, became insolvent as a result of the transfer, or was engaged in business with insufficient or unreasonably small capital. The Uniform Fraudulent Transfer Act (UFTA), which has been adopted by most states, does not define "reasonably equivalent value," making the defense of claims all the more problematic for the buyer. The determination of whether the buyer paid "reasonably equivalent value" is a fact-sensitive determination that examines, among other things, the fair value of the assets, the amounts paid, and other indirect benefits the buyer may have received.

Whether the seller was insolvent at the time of the transfer is also not necessarily as easy a determination as it would seem to be, in part because insolvency can be measured by multiple yardsticks:

- Balance Sheet Test (do liabilities exceed assets?);
- Cash-Flow Test (is the debtor generally able to pay its debts as they come due?); and
- Adequate Capitalization Test (does the debtor have unreasonably small capital to sustain its planned operations?).

Transfers up to four years old can be avoided under UFTA; and in New York, this lookback period extends to six years. And, if the seller files for bankruptcy before this time elapses, the seller's bankruptcy estate gets an additional two years to file suit. Accordingly, it may be a long time before a buyer can rest easy after acquiring assets at "fire sale" value.

## Fraudulent Transfer Scenario

There are many cases involving fraudulent transfer claims being asserted against buyers of businesses. One such illustrative case is *Vital Pharmaceuticals, Inc. v. USA Sports, LLC*<sup>[1]</sup>. *Vital Pharmaceuticals* involved plaintiff VPX's efforts to hold USA Sports liable for over \$500,000 in products delivered to Boss Nutrition (Boss), for which payment was never received. VPX obtained a judgment against Boss in Florida but was unable to collect because Boss sold its assets, alleged to be worth \$3.3 million, to USA Sports for \$2.2 million. The asset sale included inventory, accounts receivable, and other intangible assets, and left Boss with virtually no assets. USA Sports also retained multiple Boss employees, operated out of the same location, and engaged in a virtually identical business to the one run by Boss.

In suing USA Sports, VPX asserted several successor liability causes of action, including claims that Boss fraudulently transferred the assets of its business. In denying USA Sports's Motion to Dismiss, the Middle District of Pennsylvania ruled that USA Sports stated a valid fraudulent transfer claim. Among other things, the court decided that VPX properly alleged that the value of the transferred assets was not reasonably equivalent to the consideration that USA Sports paid to Boss. Further, the court considered that the question of whether the buyer received reasonably equivalent value for its assets inherently involves questions of fact, which typically are for the jury to resolve.

## Risk Mitigation Strategies

Although there is probably no absolute way to keep an aggrieved creditor from suing, there are common-sense ways to mitigate the risks of being sued and of being found liable for a fraudulent transfer. Perhaps the most important risk-mitigation strategy is for the buyer to obtain an appraisal of the fair value of seller's business or assets before completing the sale. The success of a fraudulent transfer claim depends on the creditor's ability to prove that the seller did not receive reasonably equivalent value for the business or asset sold. If prior to the sale, the parties obtain a fair-value opinion from an independent third party, the transaction is inherently more defensible. With an independent appraisal in hand, it becomes more difficult for the creditor to argue that the parties engaged in a sale simply to avoid the seller's obligation to pay its creditors or that the transaction was structured in a way to pay secured and guaranteed debt and without regard to the true value of the business or the business's assets. That said, it is important to choose an appraiser carefully and for the appraiser to scrutinize any information provided by seller to avoid a "garbage in, garbage out" scenario. If creditors challenge the independence of the appraisal, your appraiser must be prepared to stand behind his or her work.

Alternatively, buyers may have more comfort if the seller is represented by an investment banker who actively markets the assets before entering into a definitive agreement. Investment bankers typically keep detailed records of the sales leads, executed non-disclosure agreements, and offers received, among other objective data that can be used to show that the price paid, in fact, represented the fair value of the assets as determined by the market at the time — even if, due to the pandemic, that value was at a low point.

Finally, a buyer of a distressed business should do its homework on the seller's liabilities. If a seller's distress is sufficiently deep, it may be advisable to insist it seek Chapter 11 protection and structure the transaction as a Section 363 sale under the auspices of bankruptcy court approval. Previous concerns about the time and cost associated with a bankruptcy filing are mitigated because of the recently passed Small Business Reorganization Act, which went into effect in February 2020 and offers a quicker and cheaper path through Chapter 11 for businesses with debt less than \$7.5 million.

## Conclusion

By definition, investments involve inherently risky activities. Where there is a bargain to be had, buyers of failing businesses can easily be lured into deals without fully analyzing the hidden risks. One such hidden risk involves the buyer potentially being saddled with the debt of the seller. Situations in which the selling company has substantial unsecured debt are particularly ripe for fraudulent transfer claims. Buyers of failing companies need to be aware of the potential that landlords, unsecured lenders, trade creditors, and others may be looking for creative ways to recover amounts that they are owed by alleging that failing companies were sold for less than fair value at a time while the selling company was insolvent. If buyers are aware of these potential claims, they can mitigate risks and hopefully keep a good deal from becoming an unprofitable one.

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As we continue to monitor the novel coronavirus (COVID-19), White and Williams lawyers are working collaboratively to stay current on developments and counsel clients through the various legal and business issues that may arise across a variety of sectors. Read all of the updates [here](#).

[1] *Vital Pharmaceuticals, Inc. v. USA Sports, LLC*, 2012 U.S. Dist. LEXIS 31398 (M.D. Pa. Mar. 8, 2012)

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