

April 2013

Stock Sale Protected

Chem Rx Corporation was a family owned business. In a leveraged buyout (LBO) of Chem Rx, the acquiring entity used loan proceeds to purchase all of Chem Rx's stock and secured that loan with a security interest in all of Chem Rx's assets. Three years after the LBO, Chem Rx sought bankruptcy protection and was liquidated. A litigation trust formed in the bankruptcy case sued the former shareholders to recover the amounts paid for the stock, alleging a constructively fraudulent transfer.

The litigation trust argued that the economic affect of the LBO was to transfer the value of Chem Rx's assets to its former shareholders, for which Chem Rx received nothing in return. This transfer left Chem Rx insolvent, unable to pay its other creditors.

The former shareholders defended this suit based on a provision of the bankruptcy statute, which does not permit a bankruptcy estate to reverse and recover any transfer that is a "settlement payment". The courts have defined "settlement payment" as a transfer of cash or securities made to complete a securities transaction. The New York federal court agreed that the sale of Chem Rx stock was a protected securities transaction, even though no publicly traded stock was involved.

AP Services LLP v. Silva, 483 B.R. 63 (S.D.N.Y. 2012).

Less Protection for LLC's

In the more than two decades since its introduction, the limited liability company (LLC) has become a preferred vehicle for the operation of small businesses. The LLC

combines some of the simplified management and creditor protection aspects of a partnership with the limitations on owner liability of a corporation.

Among the creditor protections is a provision of the Uniform Limited Liability Company Act, which provides that when a member of an LLC files a bankruptcy petition that member is "disassociated" and loses the right to participate in the management and conduct of the company's business. This provision is designed to prevent a bankruptcy trustee or creditors of the insolvent member from influencing the management of the LLC to the detriment of the remaining members.

A West Virginia bankruptcy judge recently held that this provision violates the federal bankruptcy statute. The court reasoned that a member's management rights are property of the bankruptcy estate which may be exercised by a trustee for the benefit of the member's creditors. Thus, a Chapter 7 trustee could seek judicial dissolution of an LLC and the liquidation and distribution of its assets to himself and the other members.

Sheehan v. Warner (In re Warner), 480 B.R. 641 (Bankr. N.D.W.Va. 2012).

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This newsletter is intended to inform its readers of developments in the area of debtor/creditor relations. It is not legal advice or a legal opinion regarding any specific matter. You should consult a lawyer regarding any questions relating to your particular situation. Congress has required bankruptcy attorneys to state: "I am a debt relief agency. I help people file for bankruptcy relief under the Bankruptcy Code." 11 U.S.C. § 528.