CLIENT MEMORANDUM

District Court Overturns Bankruptcy Court in *Lyondell* Fraudulent Transfer Litigation, Rules CEO's Fraudulent Intent May Be Imputed to Corporation

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AUTHORS

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On July 27, 2016, in a case that arose out of the leveraged buyout of Lyondell Chemical Company ("Lyondell"), Judge Denise Cote of the United States District Court for the Southern District of New York (the "District Court") issued a ruling in *Weisfelner v. Hoffman (In re Lyondell Chemical Co.)* holding that the fraudulent intent of the CEO of Lyondell may be imputed to the corporation under Delaware law. Judge Cote also articulated a standard to prove actual intent, which requires evidence of either the debtor's desire to cause the consequences of its actions or its belief that such consequences were substantially certain to result. The decision overturned an earlier ruling by Judge Robert Gerber of the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court"), which held that the CEO's intent could be imputed to Lyondell only if the CEO was in a position to control Lyondell's Board of Directors (the "Board").

A. Background

In August 2006, investor Leonard Blavatnik identified Lyondell, a publicly traded petrochemicals company, as an acquisition target and made an initial offer to acquire the company at a price of $26.50 to $28.50 per share. Dan Smith, then-CEO and Chairman of Lyondell, instructed the Board to reject this offer pending a "strategic update" in October 2006. The company's unsecured creditors argue that the update included an EBITDA projection inflated by over $5 billion to support a higher stock value, which the Board nonetheless adopted as part of the company's 2007 Long Range Plan

(the "LRP"). Several months later, in May 2007, Blavatnik announced that he had acquired 10% of the company's stock and was interested in acquiring the rest of the company. According to the unsecured creditors, Smith then instructed the company's Manager of Portfolio Planning to improperly add approximately $2 billion of additional EBITDA to the 2007 LRP. Smith began private negotiations with Blavatnik in June 2007, ultimately receiving an offer of $48 per share for the company in July 2007. Smith presented the new projections to the Board, which authorized management to continue negotiating with Blavatnik. According to the unsecured creditors, Lyondell's senior management made one due diligence presentation to Blavatnik's representatives, after which the parties signed a merger agreement.

The leveraged buyout, which closed on December 20, 2007, was financed in full by debt secured solely by Lyondell's assets. The company took on approximately $21 billion of new debt, of which $12.5 billion was paid to shareholders. The Board received over $19 million in related consideration. By February 2008, the company was suffering from negative liquidity, and it filed for bankruptcy in January 2009.

The events surrounding the leveraged buyout are the subject of three adversary proceedings brought on behalf of Lyondell's unsecured creditors by the trustee (the "Trustee") of two creditor trusts created by the company's chapter 11 plan. The Trustee claims that the Board knew that the transaction would leave the company inadequately capitalized and that a bankruptcy or restructuring in which the company's creditors would not be paid could occur. In each of the adversary proceedings, the Trustee asserts intentional fraudulent transfer claims against certain of the company's shareholders under either section 548 of the Bankruptcy Code or state fraudulent transfer law.[1]

B. The Bankruptcy Court's Opinions

The Bankruptcy Court granted the shareholders' motions to dismiss in each of the actions commenced by the Trustee, holding that Smith's intent could not be imputed to Lyondell. Relying on the First Circuit's decision in *In re Roco Corporation*,[2] the court held that the standard for imputation is "whether the individual whose intent is to be imputed was in a position to control the disposition of [the transferor's] property." Because Delaware law requires a corporation's board of directors to approve a merger or leveraged buyout, the Bankruptcy Court held that the Board – not Smith – was the relevant actor with respect to the debtors' actual intent to hinder, delay, or defraud creditors. The Bankruptcy Court also held that the Trustee failed to plead facts supporting a finding either that a critical mass of the Board had such intent or that Smith could nonetheless control the disposition of Lyondell's property such that his intent should be imputed to the corporation.

After the Trustee filed amended complaints in each proceeding and the shareholders renewed their motions to dismiss, the Bankruptcy Court dismissed the intentional fraudulent transfer claims with prejudice, noting that Lyondell was a company with a "functioning board" (as opposed to a closely held corporation) and emphasizing that the Board's intent was thus critical. The Trustee filed an appeal challenging the Bankruptcy Court's rulings that the conduct of Lyondell's CEO could not be imputed to the corporation and that the Trustee had failed to adequately allege actual intent.

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[1] Judge Cote's opinion applies in each proceeding.

[2] 701 F.2d 978 (1st Cir. 1983).

C. The District Court's Opinion: Imputation

The District Court overruled the Bankruptcy Court on the question of imputation, holding that Smith's fraudulent intent can be imputed to Lyondell under Delaware law. Citing to the United States Supreme Court, the District Court first noted that state law governs imputation for the purposes of section 548 of the Bankruptcy Code.[3] Because Lyondell is a Delaware corporation that engaged in a merger governed by Delaware law, the District Court applied Delaware law, which holds corporations liable for the actions of their agents "even when the agent acts fraudulently or causes injury to third persons through illegal conduct."[4] As this rule is derived from general principles of agency, the District Court noted that the corporate agent's conduct must be performed within the scope of his or her employment, and that a corporate officer performing "the everyday activities central to any company's operation and well-being" is acting within the scope of his or her employment. In this case, the court highlighted that Smith's actions with respect to the projections and negotiations were performed pursuant to his duties as CEO and Chairman.

With respect to the distinction between companies with boards and closely held corporations, as well as the requirement that the Trustee demonstrate Smith's control over the Board, the District Court ruled that the Bankruptcy Court's holdings "do not appear to have any basis in Delaware agency law." Moreover, the District Court noted that the Bankruptcy Court's reliance on *In re Roco Corporation* was misplaced, as that case examines whether knowledge of *transferees* receiving corporate assets (rather than agents, for whom courts apply different standards)[5] may be imputed to the transferor corporation.

D. The District Court's Opinion: Actual Fraud

Because Smith's intent could be imputed to Lyondell, the District Court stated that the adequacy of the Trustee's pleading of actual fraud must be reconsidered. Section 548(a)(1)(A) requires "actual intent to hinder, delay, or defraud any entity to which the debtor was or became . . . indebted." The District Court noted that actual intent may not be presumed, although the Trustee argued that a lower standard is appropriate because debtors are presumed to intend the "natural consequences" of their actions. Rather, the District Court applied the standard articulated by Judge Learned Hand in *In re Condon*,[6] which requires proof of an actor's "mental apprehension" of the consequences of his conduct, and the equivalent formulation in the Restatement (Second) of Torts, which states that "[t]he word 'intent' is used . . . to denote that the actor desires to cause the consequences of his act, or that he believes that the consequences are substantially certain to result from it."[7]

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3 *See O'Melveny & Myers v. FDIC*, 512 U.S. 79 (1994).

4 *Stewart v. Wilmington Trust SP Servs., Inc.*, 112 A.3d 271 (Del. Ch. 2015).

5 *In re Adler, Coleman Clearing Corp.*, 263 B.R. 406 (S.D.N.Y. 2001).

6 198 F. 947 (S.D.N.Y. 1912).

7 Restatement (Second) of Torts § 8A.

In addition to establishing the standard of proof for actual fraud, the District Court also held that intentional fraudulent transfer claims must satisfy the heightened pleading standards set forth by Rule 9(b) of the Federal Rules of Civil Procedure, which requires facts giving rise to a "strong inference" of fraudulent intent. The District Court noted that, because actual intent is difficult to prove, the pleader may rely on "badges of fraud." Although the Bankruptcy Court did not impute Smith's intent to the corporation, both the Bankruptcy Court and the District Court found that three badges of fraud had been adequately pled in this case: the transfer was of substantially all of the debtors' assets, the transfer was to an insider (as directors received "large" cash payments), and the debtor became insolvent shortly after. As a result, the District Court held that the Trustee had created a plausible inference of the debtors' actual intent to defraud creditors.

E. Observations

Although Judge Cote's decision in *Lyondell* represents a victory for the company's unsecured creditors, the Trustee still must prevail at trial to claw back the $6.3 billion in payments made to shareholders in connection with the LBO. The unsecured creditors may face obstacles at trial, as the opinion notes that the shareholders have presented facts controverting the Trustee's assertions that Smith acted with actual knowledge that the transaction would render the company insolvent. Even if the Trustee can prove actual fraud, Judge Cote also notes that the intent of an agent may not be imputed to a corporation when the agent "was acting solely to advance his own personal financial interest," a principle that was neither addressed nor relied upon by the parties in the pleadings leading to this opinion.

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