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Transferee Liability under New York Law: 'Dillon Trust Co. v. United States'

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Under some circumstances, sellers of stock of a corporation may be liable as transferees for corporate obligations arising before or in connection with the closing. In *Dillon Trust Co. v. United States*, 132 AFTR 2d 2023-6368 (Ct. Fed'l. Cl.), the Court of Federal Claims concluded, under New York fraudulent conveyance law, that the sellers of the stock of two corporations were liable for tax obligations of the corporations attributable to sales of assets for notes prior to the closing of the stock sale. The sellers were also liable for the corporations' tax obligations attributable to sales of the remaining corporate assets immediately *after* the closing, where the sellers had reason to be concerned that the buyer would not cause the corporations to pay those taxes.

Facts in *Dillon Trust*

Nine trusts relating to one family owned the stock of Humboldt Corporation, and Humboldt and certain of those trusts owned the stock of Shelby Corporation. Each of the corporations was a C corporation for tax purposes and owned farmland and a blue-chip stock portfolio the income from which was used to help fund farming operations.

It was determined in 2001 and 2002 that the land should be sold. Taking into account the low tax bases of the two corporations in the land, those sales would lead to the recognition of substantial gains and imposition of corporate income tax on those gains, and to further taxes on the shareholders if proceeds from the sales were distributed to them.

The Dillon family and their advisors considered various strategies to minimize the corporate and shareholder tax obligations projected to result from the liquidation of the farms. They ultimately determined that the stock of both corporations should be sold once the farm sales had been completed. The farm sales were effectuated in consideration of notes from the buyers backed by standby letters of credit (the Notes), which deferred the reporting of the resulting gains until after the sales of the stock of Humboldt and Shelby (Stock Sales) could be completed.

The sellers' attorneys were instructed to run what was termed an "auction" to effectuate the Stock Sales, with the winning bid to reflect payment of the proposed purchase price in cash at the closing. The auction process included discussions with five potential bidders, three of which were large banks.

The highest bid was submitted by Diversified Group Incorporated (DGI), of which James Haber was President, and provided for a payment equal to 95.14% of the value of the underlying assets of the corporations. That bid was accepted by reason of offering the best price, and notwithstanding that the sellers and their business and legal advisers had not previously heard of DGI and lacked any knowledge about DGI or its principal.

A stock purchase agreement was negotiated in late November and December 2002 that provided for the purchase of the stock of both corporations by a newly formed Delaware corporation ("HSHC") with principal offices in New York. Haber was the sole stockholder of HSHC, and he simultaneously negotiated financing to be provided by an affiliate of Rabobank. The financing agreements effectively required that, prior to closing, HSHC and an identified broker enter into an agreement for the purchase by the broker of the Humboldt and Shelby stock portfolios.

Haber informed representatives of the sellers during the negotiations that Humboldt and Shelby would sell the Notes to Rabobank shortly after the closing of the Stock Sales, and that arrangements needed to be made such that Rabobank would become a beneficiary of the letters of credit securing the Notes.

The draft stock purchase agreement initially provided that each of the corporations "will retain a substantial portion of its assets" for a period not specified in the opinion. Buyer's counsel asked that this be changed to provide that each corporation "will retain substantial assets," and the sellers accepted that change. Also, in lieu of language sought by the sellers to the effect that each of the Notes would be retained by the relevant corporations for at least one year from the date of issue, the final agreement required that one of the Notes be retained until January 1, 2003, and that the other Notes be retained until July 1, 2003.

The Stock Sales closed on December 23, 2002. The $86.8 million purchase price paid by HSHC to the sellers was provided by Rabobank through a loan to HSHC. The corporations' stock portfolios were sold on the day of the closing for $50.5 million, and additional amounts totaling $33.6 million were immediately borrowed by Humboldt and Shelby from Rabobank through additional loans secured by the Notes. The purchase price loan was repaid to Rabobank within four days after the closing.

HSHC filed a consolidated federal tax return with Humboldt and Shelby for a taxable period beginning on the date of closing and ending on November 30, 2003. The return reported gains totaling $73.2 million from the sales of the stock portfolios and the Notes, and offsetting losses in a slightly greater amount from transactions referred to in the opinion as "Son-of-BOSS transactions." Those losses were disallowed by the IRS as attributable to "tax shelter" transactions that lacked economic substance, and the disallowance was sustained by the Tax Court and on appeal to the Court of Appeals for the Second Circuit (*Humboldt Shelby Holding Corp. v. Commissioner*, TC Memo 2014-47, affirmed, 115 AFTR2d 2015-2042 (2d Cir.)).

HSHC did not pay the tax, interest, and penalty asserted against it, and notices of transferee liability under IRC section 6901 were issued by the IRS to the selling trusts in October 2016. The trusts paid the asserted liabilities and then filed suit in the Court of Federal Claims for refunds on the basis that they were not liable as transferees.

Discussion

Transferee liability under Internal Revenue Code section 6901 was described in the *Dillon Trust* opinion as involving a two-part test. First, each person asserted to be liable as a transferee must be a "transferee" as defined under federal law for purposes of section 6901. Second, it must be determined that the transferee is liable under applicable state law for debts of the transferor.

Section 6901(h) states that the term "transferee" includes a "donee, heir, legatee, devisee, and distributee," and Reg. section 301.6901-1(b) further provides that the term includes "the shareholder of a dissolved corporation, the assignee or donee of an insolvent person, the successor of a corporation, a party to a reorganization as defined in section 368, and all other classes of distributees." The court concluded that the trusts were transferees of HSHC by reason of the trusts' receipt of the proceeds of the Stock Sales.

The opinion then discusses whether the sellers were liable for tax owed by HSHC under applicable state law, namely the constructive fraud provision of the Uniform Fraudulent Conveyance Act as adopted by the State of New York in section 273 of the New York Debtor and Creditor Law.

Debtor & Creditor Law section 273, as in effect at the time of the sale, provided that a conveyance made by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without respect to the person's actual intent "if the conveyance is made . . . without a fair consideration." Under Debtor & Creditor Law section 272 as then in effect, fair consideration is given for property or an obligation "[w]hen in exchange for such property, or obligation, as a fair equivalent therefor, and in good faith, property is conveyed."

After lengthy discussion of another case applying New York fraudulent conveyance law, the court concluded that, in determining whether fair consideration was received, the Stock Sales, funded through a loan, the sales of assets of the two corporations (and pledges of assets as collateral for additional borrowings), and the use of the proceeds from the asset sales and pledges to repay the loan should be stepped together. Once the transactions were collapsed in this manner, it because apparent that the consideration received by HSHC -- that is, the stock of Humboldt and Shelby -- was not a fair equivalent for what it paid, and that the steps caused HSHC to not have sufficient funds to pay the tax incurred by reason of the asset sales and therefore made HSHC insolvent.

Whether the transactions should be collapsed into a single transaction was dependent, according to the court, on whether the sellers knew or should have known of DGI's plans. The court found that it was not necessary, in order to collapse the steps, to prove that the sellers had actual knowledge that Haber intended to cause the corporations to sell the assets without paying the resulting tax. Rather, it was sufficient if the government established that there were indications of the potential for tax fraud and that the sellers chose to remain ignorant rather than to make further inquiry.

In that regard, the court found that the sellers' knowledge that Haber was making the acquisition through a newly formed corporation owned by Haber, with no likelihood of HSHC's having net operating loss carryovers or other historical tax attributes that might offset the gains expected to result from the sales of assets, their lack of significant inquiry into Haber's plan to address the tax obligations that would ordinarily result from the contemplated sales of assets, and other circumstances discussed in the opinion put the sellers in a position of "willful ignorance" that was sufficient to demonstrate constructive knowledge of fraud, and established that the sellers did not act in good faith.

Therefore, the government was entitled to the remedies against the sellers as transferees that were set forth in the New York Debtor & Creditor Law for fraudulent conveyances, and the sellers were consequently liable for the tax obligations of HSHC under New York law and IRC section 6901.

Observations

It is not entirely clear from the opinion how the court "connected the dots" in certain respects -- for example, as to whether it concluded that the collapsing of steps under New York law caused the sellers to be indirect transferees through HSHC of the corporations which sold the assets and incurred the gains, for purposes of section 6901. Setting this aside, however, *Dillon Trust* and transferee liability cases referenced therein underscore that there appears to be a greater burden on sellers now than might have been thought to be the case twenty or more years ago to inquire about the buyer's resources and plans. At least where the circumstances otherwise suggest that a large tax obligation will result from transactions expected to occur soon after the closing of a sale of the stock of a corporation and that the buyer may not have the resources to satisfy that obligation, due diligence is in order.

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