In re Vaso Active Pharmaceuticals: A Study in Fraudulent Transfers to Insiders

Tara L. Lattomus
Special to the Delaware Business Court Insider | October 31, 2012

In *In re Vaso Active Pharmaceuticals*, Adv. Case No. 11-52005 (Bankr. D. Del. Oct. 9, 2012), the U.S. Bankruptcy Court for the District of Delaware undertook an in-depth analysis of whether certain payments to insiders constituted fraudulent conveyances. Vaso was founded in 2001 by John Masiz and marketed over-the-counter products developed by a company called BioChemics Inc. BioChemics was also founded and controlled by Masiz, its majority shareholder. At the time of the bankruptcy filing, Joseph Frattaroli was CEO and president of Vaso. The issue before the court was whether certain payments to Masiz and Frattaroli (the defendants) by Vaso from the proceeds of a settlement between Vaso and a third party were recoverable. Pending before the court was the avoidance action trustee's motion for summary judgment.

In 2003, Vaso made an initial public offering of its stock with the assistance of Robinson & Cole. As a result of the IPO, Vaso was sued in a number of class action suits and by the SEC, and believed that it had a claim against Robinson for negligent legal advice. The suits were settled and Masiz agreed to refrain from serving as an officer or director of a public company for five years, according to the opinion. This included Vaso. However, he continued to serve as Vaso's corporate strategist with the same salary, but lacked the ability to bind Vaso.

Thereafter, in August 2005, Iroquois Master Fund, as lead lender, loaned Vaso $2.5 million secured by a blanket lien on Vaso's property, including the claim against Robinson. In early 2006, Vaso stopped paying Masiz his salary. Later that year, Vaso sued Robinson and was represented by Kelley Drye & Warren. The Kelley Drye fee agreement provided that it would receive 100 percent of its fees at the normal billing rate plus a 25 percent interest in a settlement or verdict. Notwithstanding Iroquois' blanket lien, the fee agreement also granted a lien against any recovery from Robinson that was estimated at the time to be between $30 million and $60 million.

Vaso defaulted on the Iroquois loan in May 2007 and essentially shut down, according to the opinion. Frattaroli's salary was deferred beginning in May 2008. In addition, in 2009, the underlying court in the Robinson suit entered a number of orders causing the maximum recovery potential to be reduced to approximately $4.5 million. Also during the pendency of the Robinson suit, Vaso's board of directors approved an agreement with Masiz and Frattaroli that they would be paid their back wages only if the Robinson suit was successful.

On December 19, 2009, the Robinson litigation was settled in exchange for the payment of $2.5 million. Neither Kelley Drye nor Masiz nor Frattaroli were parties to the settlement agreement. Under the Kelley Drye fee agreement, the firm would have been entitled to $1.88 million of the settlement. However, Vaso and Kelley Drye entered into a separate settlement agreement whereby the firm received $595,000 and the balance of $1.9 million was paid over to Vaso with an acknowledgment that $904,000 of that amount would be paid to Masiz and Frattaroli as

accrued wages. Thereafter, Vaso paid Masiz and Frattaroli an additional $195,190 for regular wages, leaving Vaso with a total of $804,810 of the Robinson settlement proceeds.

Masiz and Frattaroli first argued that the transfers weren't fraudulent because they were earmarked for them and never property of the estate. The court disagreed, finding that in order for funds to be earmarked, there had to be an agreement between Robinson and Vaso that the funds would be used to pay Masiz and Frattaroli and that agreement did not exist. The Kelley Drye settlement agreement referenced payments to the defendants, but Robinson was not a party to that agreement.

The court then examined whether the transfers were made with actual intent to hinder, delay or defraud Vaso's creditors. As Vaso is a corporation, the court considered whether the intent of Masiz and Frattaroli could be imputed to Vaso. In order to determine whether imputation was appropriate, the court considered: (1) whether the defendants possessed actual intent to hinder, delay or defraud; (2) whether the defendants were in a position to dominate or control the debtor; and (3) whether the domination or control related to the disposition of the debtor's property. With respect to the first prong of the imputation theory, the court concluded that the trustee was entitled to summary judgment on five of the seven applicable badges of fraud, which was sufficient to establish the defendants' intent. Specifically, the court determined that there was no genuine issue of material fact with respect to the facts that the transfers were to an insider; the transfers were concealed; the transfers were of substantially all of Vaso's assets; Vaso removed or concealed the assets; and Vaso was insolvent at the time. Regarding the second prong of the imputation theory, "domination and control," the court found genuine issues of material fact because Vaso had an independent board of directors and Masiz lacked the ability to bind Vaso. Finally, whether the domination and control of Vaso related to the disposition of its assets was tied to the second prong and, therefore, genuine issues of material fact also remained for that prong. As the trustee was entitled to summary judgment on only one prong of the imputation theory, summary judgment on the issue of actual intent was denied.

The court then considered whether the trustee was entitled to summary judgment on the theory that the transfers were constructively fraudulent because Vaso did not receive reasonably equivalent value for the transfers and was insolvent at the time of the transfers. Finding that Vaso was provided with some benefit in the form of the services provided by Masiz and Frattaroli during the years they received no salary, the court turned to the determination of whether the services provided were reasonably equivalent to the $904,000 paid to them by Vaso. Summary judgment was denied because the court found genuine issues of material fact with respect to whether Vaso received fair market value for the transfers and whether the transfers were made at arm's length.

Next, the court evaluated whether the transfers were constructively fraudulent because they were made for the benefit of an insider for an antecedent debt when Vaso was insolvent and when the defendants knew Vaso was insolvent. Summary judgment was entered with respect to Frattaroli, but not Masiz, because there was a genuine issue of material fact regarding whether he was an insider.

To the extent that summary judgment was entered, the transfers were deemed to be avoidable under Section 550 of the Bankruptcy Code. Finally, finding the "overriding theme" of the case to be the defendants' intent to pursue recovery on their own claims at the expense of all of Vaso's creditors, the court held that there was a sound basis to award prejudgment interest.

The synopsis of the opinion in this article does not give justice to the court's thorough analysis, which is evidenced by the inclusion of a table summarizing the court's rulings contained in the opinion itself.

Tara L. Lattomus is a member of Eckert Seamans Cherin & Mellott and focuses her practice in the area of bankruptcy and creditors' rights. She has extensive experience representing debtors, committees and creditors in Chapter 11 bankruptcy cases in Delaware and around the country.