

Choppy Waters in The Safe Harbor For Shareholders Of Failed LBOs?

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In this latest round of bankruptcies following failed leveraged buyouts (LBOs), former shareholders must ask themselves whether the safe harbor of Section 546(e) of the Bankruptcy Code really is as calm as it appears, or whether an approaching storm will ultimately require shareholders to pay back the money they received in the LBO.

THE SAFE HARBOR

When Congress enacted Section 546(e) of the Bankruptcy Code in 1982, it most likely did not envision the confusion and disagreement that would result. Motivated by a desire to “minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries” (H.R. Rep. No. 420, 97th Cong., 2d Sess. (1982)) and to “promote customer confidence in commodity markets generally via the protection of commodity market stability,” [see *Kaiser Steel Corp. v. Charles Schwab & Co.*, 913 F.2d 846, 849 (10th Cir.1990) (quoting Sen. R. No. 989, 95th Cong., 2d Sess. 8 (1978))

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(inner quotation marks omitted)], Section 546(e), a safe harbor statute, states, in pertinent part, as follows:

... the trustee may not avoid a transfer that is a ... settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency ... in connection with a securities contract ... that is made before the commencement of the [bankruptcy] case, except under section 548(a)(1)(A) of this title.

The safe harbor provision, therefore, protects relevant transfers, unless the transfer was made with actual intent to hinder, delay or defraud creditors. Thus, protected transfers cannot be avoided as preferential transfers or constructively fraudulent transfers. Intentional fraudulent transfer claims are not protected but are difficult to prove. To be successful on such a claim, a plaintiff must demonstrate there is a knowing intent on the part of the debtor to harm its creditors. Even the badges of fraud, which typically are used when direct evidence of fraudulent intent cannot be proven, are difficult to demonstrate in most cases.

Much deliberation has focused on the question of what is a “settlement payment” that is entitled to the protection of the safe harbor. To the frustration of many courts, Section 741(8) provides little help answering this question. The section defines

“settlement payment” as: ... a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade.

This definition has been widely criticized by courts as “circular and cryptic” (*Zahn v. Yucapia Capital Funds*, 218 B.R. 656, 675 (D.R.I. 1998)); “self-referential and unhelpful” (*Feltzer v. Mooney (In re MacMenamin’s Grill Ltd.)*, -- B.R. --, 2011 WL 1549056, *6 (Bankr. S.D.N.Y. 2011)); and “opaque” (*In re Quebecor World (USA) Inc.*, 453 B.R. 201, 203 (Bankr. S.D.N.Y. 2011)). Additionally, many courts have disagreed over the precise meaning of the phrase “commonly used in the securities trade” — does it relate to every type of settlement described in Section 741(8), or only to the final category of “other similar payment”? And what payments exactly are considered to be “commonly used in the securities trade”?

Heeding Congress’s apparent intent on making the safe harbor a tool for resolving uncertainty in the marketplace, most circuit courts of appeal analyzing Section 546(e) have found it to encompass the circumstances in front of them. Indeed, it is fairly well settled now that transfers to shareholders made in connection with the LBO of a public company cannot be avoided under a theory of constructive fraud. See, e.g., *QSI Holdings, Inc. v. Alford (In re QSI Holdings Inc.)*, 571 F.3d 545 (6th Cir. 2009) (same); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 (8th

Cir. 2009) (same); *Lowenschuss v. Resorts Int'l, Inc. (In re Resorts Int'l, Inc.)*, 181 F.3d 505 (3d Cir. 1999) (transfers to shareholders in an LBO of a publicly traded corporation were "settlement payments" within the meaning of 546(e) because there is no requirement that the financial institution obtain a beneficial interest in the funds it handles for 546(e) to apply); *Brandt v. B.A. Capital Co. (In re Plassein Int'l Corp.)*, 590 F.3d 252 (3d Cir. 2009) (holding that buyout payments to shareholders of acquired corporations were "settlement payments" protected from avoidance, despite the fact that the securities in question were privately held, rather than publicly traded and notwithstanding lack of a true "settlement process" involving a clearinghouse intermediary); *Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.)*, 952 F.2d 1230 (10th Cir. 1991).

But not all courts have readily adopted this shareholder-friendly approach. For example, in *Munford v. Valuation Research Corp. (In re Munford, Inc.)*, 98 F.3d 604 (11th Cir. 1996), the Eleventh Circuit Court of Appeals held that Section 546(e) "does not bar the trustee in bankruptcy from avoiding payments the debtor corporation made to its shareholders in a leveraged buy-out," because the transfer was made directly to the shareholders and not a commodity broker, financial institution, or other entity listed in Section 546(e). Similarly, many lower courts have concluded that leveraged buy-outs are ineligible for Section 546(e)'s protection. See *Geltzer V. Mooney (In re MacMenamin's Grill Ltd.)*, -- B.R. --, 2011 WL 1549056 (Bankr. S.D.N.Y. April 21, 2011) (payments that former shareholders in closely-held corporation received in connection with LBO of corporation's stock were not "settlement payments," such as trustee of corporation's Chapter 11 estate was statutorily barred from avoiding as constructively fraudulent); *Zahn v. Yucapia Capital Funds*, 218 B.R. 656 (D.R.I. 1998) (same); *Jewel Recovery, L.P. v. Gordon*, 196 B.R. 348 (N.D. Tex. 1996) (same); *KSC Recovery, Inc. v. First Boston Corp. (In re Kaiser Merger Litigation)*, 168 B.R. 991 (D. Colo. 1994) (shareholder group, which received a \$14.5 million dollar payment from the

debtor in exchange for acquiescence in the LBO, failed to show that option to purchase shares of preferred stock that the shareholder group would receive if the LBO were consummated was a "settlement payment").

THE SAFE HARBOR EXPANDED

While courts have differed over the precise meaning of the safe harbor provision, one court has recently come forth with a bold and wide-ranging interpretation. In *Enron v. Alfa (In re Enron)*, 651 F.3d 329 (2d Cir. 2011), the Second Circuit Court of Appeals (the Court) affirmed the district court's decision granting summary judgment in favor of noteholders from whom Enron purchased commercial paper prior to the paper's maturity. Enron brought an adversary proceeding against approximately 200 financial institutions to avoid and recover the redemption payments, totaling over \$1.1 billion on the grounds that the redemption payments constituted preferential payments or constructively fraudulent transfers. The defendants argued that these redemption payments constituted "settlement payments" protected from avoidance under the safe harbor. The Court agreed.

The significance of the *Enron* decision is not in its particular facts, but rather in its broad statements regarding the scope of the safe harbor. The Court read the definition of "settlement payment" to mean any settlement payment is a covered settlement payment and any other similar payment commonly used in the securities trade also is a covered settlement payment. Additionally, the Court disagreed with other decisions that required the securities transaction to involve a purchase or sale in order to constitute a qualifying "settlement payment" eligible for safe harbor protection. Rather, the Court found a "settlement payment" is simply any transfer made to complete a securities transaction. Finally, the Court held that the absence of a financial intermediary that takes title to the transacted securities during the course of the transaction is not a proper basis on which to deny safe harbor protection. The Court cited

to several sister circuit decisions that had considered the issue in the context of failed LBOs and concluded that the risk of disrupting the stability of the financial markets was too great to not apply the safe harbor protections to such transactions.

Taken together, these three interpretations broaden the safe harbor to cover an astounding variety of situations and circumstances. A lengthy dissent warned that "the breadth of the Court's definition [of the term settlement payment] threatens routine avoidance proceedings in bankruptcy courts ... [the goals of] preventing a 'race to the courthouse' and ensuring equality of distribution among creditors are severely undermined by the interpretation of Section 546(e) adopted by the Court." Only a month after *Enron* was decided, the Bankruptcy Court for the Southern District of New York had the opportunity to examine the decision and apply it in a different factual scenario. In *In re Quebecor World (USA) Inc.*, 453 B.R. 201 (Bankr. S.D.N.Y. 2011), the debtors transferred approximately \$400 million to noteholders, who were then sued for the return of the "preferential" transfers. Despite the different circumstances (for example, *Quebecor* involved private, rather than public notes), the *Quebecor* decision directly applied *Enron*, stating that the previous analysis courts were required to do in order to determine whether a certain transfer qualified as a "settlement payment" was now replaced by *Enron*'s simplified and broad catchall definition of a settlement payment as a "transfer of cash to complete a securities transaction." *Id.* at 204.

Regardless of the potential problems flagged by the *Enron* dissent and the *Quebecor* decision, *Enron*, coming out of the influential Second Circuit, may very well lead other courts to adopt an expansive interpretation of the safe harbor provision, thus providing a high degree of comfort for shareholders who received settlement payments and are facing the prospect of disgorging funds received in connection with a failed LBO transaction. After all, Congress has spoken and has determined that risk to the securities market and market confidence is too great to

permit disgorgement of payments in situations where the entity that issued the securities goes into bankruptcy.

CHOPPY WATERS?

Adding some chop to the normally tranquil waters of the safe harbor, however, clever plaintiffs have been crafting ways to possibly avoid the applicability of Section 546(e). This creativity is evident in two failed LBOs involving large public companies — Tribune Company and Lyondell Chemical Company.

In 2007, both Tribune and Lyondell approved a form of LBO that permitted their respective shareholders to receive cash payments in exchange for their equity positions. These transactions left the companies with a secured debt overhang that time proved neither company could effectively service. As a result, Tribune and Lyondell each filed for Chapter 11 protection in 2008 and 2009, respectively. *See In re Tribune Company, et al.*, Case No. 08-13141 (Bankr. D. Del.) and *In re Lyondell Chemical Company, et al.*, Case No. 09-10023 (Bankr. S.D.N.Y.).

Tribune

The creditors' committee in *Tribune* filed a complaint which, among other things, sought to disgorge cash shareholders received in connection with the LBO. Apparently anticipating the safe harbor provision would not permit recovery from shareholders on the grounds of constructive fraud, the committees' complaint omitted such a count against the shareholders. The complaint, instead, sought recovery from shareholders on a theory of intentional fraud, for which the safe harbor offers no protection.

Apparently dissatisfied with the intentional fraudulent transfer count filed by the committee, a group of unsecured note holders sought and received permission from the bankruptcy court to file their own complaint against the shareholders seeking to avoid the cash payments shareholders received in connection with the LBO on the grounds of state law constructive fraudulent transfer theories. While the bankruptcy court did permit the note holders to pursue

these claims, to the extent they may exist, the court did not rule that such claims do in fact exist, or that if they do, that the claims belong to the creditors. *See In re Tribune*, order entered April 25, 2011 [docket no. 8740].

Given the green light by the bankruptcy court, the note holders have filed in excess of 40 complaints in various courts around the country implicating thousands of shareholders under state law constructive fraud allegations, which if successful, will cause turnover of the very same funds the creditors' committee is pursuing. All of these various note holder actions recently have been consolidated in the Federal District Court for the Southern District of New York pursuant to the Multi District Litigation rules. To the delight of shareholders, the District Court has stayed substantive activity in the consolidated case. The bankruptcy court has stayed the committee's case as well.

Lyondell

A year newer and perhaps a year wiser, the powers that be in the *Lyondell* case took a different tack in their attempt to evade the safe harbor. In *Lyondell*, the confirmed plan provided that all of the debtors' potential avoidance actions would be assigned to a litigation trust established under the plan. Excluded from that assignment were the avoidance claims under Section 544 of the Bankruptcy Code and applicable state law (e.g., state law fraudulent transfer claims) against the former shareholders. Under the plan, the debtors were deemed to have abandoned their right to pursue these excluded claims. Instead, the plan provided that the unsecured creditors (to whom presumably the abandoned claims would revert) would assign these claims to a creditors trust. Both the litigation trust and the creditors trust were authorized to pursue their respective claims for the benefit of the creditors.

Once in the trust, the working presumption was that the claims would be cleansed of the safe harbor taint and the trust would be free to pursue the claims in state court outside the purview of the bankruptcy court and the reach of the safe harbor provision (interestingly

enough, the case was removed from the state court to the federal district court and then transferred to the bankruptcy court).

Not surprisingly, this litigation strategy attracted several objections. Pending before the bankruptcy court are several motions to dismiss the constructive fraud claims. The arguments are principally based on the federal preemption rule. Simply put, the shareholders contend that Congress imposed federal limits on the avoidance of pre-bankruptcy settlement payments. Any laws that attempt to overstep that limit by seeking avoidance of pre-bankruptcy settlement payments, therefore, are preempted.

CONCLUSION

Given the broad scope of the safe harbor provision, shareholders who received payments in connection with a failed LBO should be able to take comfort that those funds likely cannot be recovered under a constructive fraudulent transfer theory. As plaintiffs test the waters with new and creative strategies such as ones being deployed in *Tribune* and *Lyondell*, one has to question whether the calm waters of the safe harbor will become choppy as plaintiffs attempt to circumnavigate the safe harbor provision of the Bankruptcy Code.

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