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LBO Transactions in Bankruptcy: Fraudulent Transfer Issues for Lenders, Equity Purchasers, Shareholders

Impact of Merit Management and Other Recent Case Law

THURSDAY, MAY 31, 2018

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Leveraged Buyout Transactions Challenged in Bankruptcy: Background and Selected Case Law

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Outline

- Basic LBO Structure
- Fraudulent Conveyance in the Bankruptcy Context
- Statutory Exceptions
- Case Studies
- Q&A

Basic LBO Structure

A. LBO Transaction: Purchase of stock of a corporation from the shareholders with the proceeds of loan secured by corporation's assets.

1. Hallmarks
   - Substituting debt for equity
   - Loan proceeds obtained by acquirer generally disbursed to target shareholders
   - Assets of target corporation secure loan
2. LBO Transfers Targeted in Bankruptcy
   - Debt incurred by the target company to fund LBO, and liens securing it
   - Payments made to target's former equity holders in exchange for their equity interest or assets sold in LBO
   - Fees and costs associated with or arising from the transaction
3. LBO Defendants
   - Lenders
   - Former shareholders
   - Professionals

Fraudulent Transfers in LBOs

B. Bankruptcy Code

- §548 allows avoidance of transfers made or obligations incurred within 2 years of the filing of bankruptcy petition. 11 U.S.C. §548.
- §550 allows debtor/trustee to recover the property "fraudulently" transferred from initial or subsequent transferee. 11 U.S.C. §550.
- §544 allows debtor/trustee to avoid transfers under applicable non-bankruptcy law.
- Most states have state law equivalents to §548. The Uniform Fraudulent Transfer Act allows creditors to void transfers that are intentionally or constructively fraudulent under criteria that is generally the same as §548.
- UFTA; Longer claw back period
- NY: CPLR §213 – 6 year statute of limitations (2 year discovery period)
- NJ: NSA 25:2-31 – 4 year statute of limitations (1 year discovery period)
- DE: Del. C. §1309 – same

Fraudulent Transfers in LBOs (*cont'd*)

Two types of "fraudulent transfers": intentional and constructive

1. An actual fraudulent transfer requires plaintiff to establish the transfer was made with actual intent to hinder, delay, or defraud creditors.
   - Circumstantial evidence and "badges of fraud" used to infer fraudulent intent. <u>In re Lyondell Chem. Co.</u>, 554 B.R. 635, 652-53 (S.D.N.Y. 2016) (listing 11 "badges"). Examples:
     - Relationship between the debtor and the transferee;
     - The consideration for the transfer;
     - Insolvency or indebtedness of debtors pre- and post-transfer;
     - How much of the debtor's estate was transferred;
     - Reservation of benefits, control or dominion by the debtor;
     - Secrecy or concealment of the transaction.
   - Intent of the transferor is determinative, regardless of intent of transferee
     - Intent of Board, not officers

Fraudulent Transfers in LBOs (*cont'd*)

2. A constructive fraudulent transfer involves a transfer made for less than reasonably equivalent value and the transferor was either:

   - Insolvent at the time of or rendered insolvent by the transfer or obligation; or
   - Left with unreasonably small capital, or
   - Intended to incur, debt beyond its ability to pay; or
   - Made such transfers or incurred such obligation to or for the benefit of an insider, under an employment contract, and not in the ordinary course of business

11 U.S.C. §548(a)(1)(B)

Fraudulent Transfers in LBOs (*cont'd*)

C. Reasonably Equivalent Value

- Issue arises in LBO context because the party that incurs the debt and secures the obligation (the target) generally did not receive the proceeds of the loan financing the transaction. Typically the shareholders, not the company, receive the funds.
- Defenses/Arguments often center around
  - Intangible benefits
  - Operational synergies
  - New credit opportunities
  - Good will

D. Insolvency

- Balance sheet test; whether liabilities exceed assets as of a specific date (before or immediately after the transaction).
- Generally valued on going concern basis unless bankruptcy is "clearly imminent"

Fraudulent Transfers in LBOs (*cont'd*)

E. Unreasonably Small Capital

- Test for "unreasonably small capital" is reasonable foreseeability. Moody v. Security Pacific Business Credit, Inc., 971 F.2d 1056 (3d. Cir. 1992)). At the time of the transaction, was it reasonably foreseeable that the company would have unreasonably small capital after entering into the transaction?
- Courts look at:
  - Whether projections were reasonable when made based on past performance, but accounting for potential future difficulties
  - Availability of credit
  - Other industry factors (competition, market pricing) that may have caused the debtor's problems, and whether those factors were foreseeable
  - Other financial measures
  - Debt to capital ratio in the industry
  - Public equity / debt, price of securities

Fraudulent Transfers in LBOs (*cont'd*)

F. Collapsing loan transactions. LBOs often involve several steps or a series of transactions. When a series of transactions is part of one integrated transaction, a court may look behind the exchange of funds and "**collapse**" the individual transactions to determine the overall economic impact of the transaction.

Standard: Three factors in determining whether transactions should be "collapsed":

1. Whether all of the parties involved had knowledge of the multiple transactions.
2. Whether each transaction would have occurred on its own
3. Whether each transaction was dependent or conditioned upon other transactions.

U.S. v. Tabor Realty Corp., et al., 803 F.2d 1288 (3d Cir. 1986)

CASES: Mervyn's

- Mervyn's, LLC v. Lubert—Adler Group IV LLC, et al, 426 B.R. 488 (Bankr. D.De. 2010).

  Facts:

  - Target Corp. sold Mervyn's department stores (Mervyn's) to Mervyn's Holdings, LLC, ("Purchaser") owned by 3 private equity funds, in 2004
  - purchase price of $1.175B financed by leveraged borrowing using Mervyn's real estate as collateral.
  - no loan proceeds went to Mervyn's.
  - post-closing, Purchaser transferred real estate to sister company for little or no consideration, which then leased it back to Mervyn's at significantly higher rent
  - Mervyn's filed chapter 11, and Committee sued Target and the Purchaser owners under state law, claiming the loss of the real estate, the leases, and the over-leveraged financial condition post-closing caused the bankruptcy

CASES: Mervyn's (*cont'd*)

- alleged the transfers were actually and constructively fraudulent, and breaches of fiduciary duty
- on motion to dismiss, court found collapsing appropriate. Execution of sale agreement, post-closing transfer of real estate, transfer of leases, and loans collapsed into a single transaction to view the overall economic consequences.
- Allegations supported finding that (a) Target had constructive knowledge of the transactions; (b) Transactions would not have taken place on their own; (c) Transactions were mutually dependent upon each other.
- Overall economic consequences were "devastating" to creditors, including "stripping" of real estate, increasing rents, and creation of an economic conflict of interest at the parent level. LBO left debtor with as little as $22M working capital and additional debt of over $800M.
- §546(e) settlement payment exemption does not apply to "collapsed" transactions. Once collapsed, there was no "settlement payment" within meaning of §741 because the real estate transfers were not sales of securities

CASES: Mervyn's (*cont'd*)

- Compare, Mervyn's, 426 B.R. 104 (Bankr. D.De. 2010) whereby the action was brought against the successor to the secured lender. PE Sponsors required Mervyn's to deposit rent payments into bank accounts initially controlled by secured lenders. Bank of America was the Trustee for the holders of the secured lenders certificates and accepted an assignment of the loans and liens. Committee sued Bank of America.

- Court granted a motion to dismiss on the failure to plead control or knowledge. Court refused to collapse transactions in absence of any allegations of either actual or constructive fraud as to Bank of America.

CASES: Boyer

- Boyer v. Crown Stock Distributing, 587 F.3d 787 (7^{th} Cir. 2009)

  Facts:

  - Sale of assets, not stock.
  - Cash retained by seller/target (i.e., not transferred with sale of assets) was upstreamed as shareholder distribution shortly *before* the sale of assets to buyer.
  - Corporate name was included in assets purchased, so creditors were not aware of transaction; analogous to stock sale.
  - Target became highly leveraged, but stayed in business for over 3 years after the sale.
  - Filed for bankruptcy, and Trustee sued to avoid transaction, recover payments to seller (which had been up-streamed as dividends to seller's shareholders).
  - Trustee also sought to recover the pre-sale dividend paid to equity from seller's assets.
  - Transaction collapsed to reflect economic reality. Held entire transaction as a fraudulent transfer and allowed recovery of all consideration, plus the pre-closing dividend – even though the total amount exceeded creditor claims, since excess funds would be returned to defendants (shareholders).

In re TOUSA, INC., 444 B.R. 613 (S.D. Flo. 2011).

- In re TOUSA, Inc., 444 B.R. 613 (S.D. Fl. 2011)
  - In 2005, home builder and developer TOUSA, Inc. and one of its subsidiaries issued unsecured guaranties in connection with a leveraged joint venture. When the joint venture failed, the JV lenders sued TOUSA as a guarantor. To settle the litigation, TOUSA agreed to pay more than $420MM to the JV lenders on the guaranties.
  - TOUSA borrowed $500MM from its own lenders to fund the settlement and pledged all of its and its subsidiaries' assets as collateral for the loan. The subsidiary pledgers were not defendants in the JV lender litigation, but the companies' financing was such that a judgment in the litigation would trigger defaults and guarantor liability of those same subsidiaries.
  - Less than six months after receipt and disbursement of the loan to fund the settlement, TOUSA and its subs filed for Chapter 11.
  - The Committee commenced an adversary proceeding alleging that the $500MM in debt and settlement payments made with the funds were fraudulent transfers. After a trial, the bankruptcy court agreed, finding that the transfers were constructively fraudulent because no reasonably equivalent value was exchanged and the entities were insolvent before and after the transfers. 422 B.R. 783 (Bankr. S.D. Fla. 2009). Court ordered avoidance of the liens, disallowance of their secured claims, disgorgement of principal, interest, costs and expenses from the lenders, plus prejudgment interest for total disgorgement in excess of $480MM.

In re TOUSA, INC., 444 B.R. 613 (S.D. Flo. 2011) (*cont'd*)

- District Court reversed. In re TOUSA, INC., 444 B.R. 613 (S.D. Fl. 2011).
- Held:
  - Debtor subsidiaries lacked property interest in proceeds of new loans used by debtor parent company to pay joint venture lenders in settlement of antecedent debt (i.e., the guaranty), as required for avoidance of fraudulent transfer.
  - Debtor-subsidiaries received value in exchange for granting liens on their assets to new lenders that provided financing for settlement payment made to joint venture lenders.
  - Debtor-subsidiaries received reasonably equivalent value in exchange for liens given to new lenders.
  - Joint venture lenders were not "entities for whose benefit" transfers of liens by debtor-subsidiaries to new lenders were made, and
  - Joint venture lenders could not be found to have acted in bad faith or with knowledge of avoidability of lien transfers, would preclude them from qualifying for exceptions to avoidance recovery.

In re TOUSA, INC., 444 B.R. 613 (S.D. Flo. 2011) (*cont'd*)

- **Court of Appeals reversed.** In re: TOUSA, INC., 680 F.3d 1298 (2012)
- Held:
  - *The Bankruptcy Court did not clearly err when reasonably equivalent value for the liens and the transferees were "entities for whose benefit" the liens were transferred.*
  - District Court rejected Bankruptcy Court's definition of value as "too narrow" and "potentially" inhibitory of contemporary financing practices."
  - 11th Circuit declined to adopt any definition of reasonably equivalent value.
  - Instead, the Appellate Court stated the Bankruptcy Court's did not clearly err when it found that all of the purported benefits, even if legally cognizable, did not confer reasonably equivalent value. Court noted that: "[t]he opportunity to avoid bankruptcy does not free a company to pay any price or bear any burden."
  - Extending an entity's existence is not necessarily beneficial.
  - JV lenders were benefitted and it made no difference that proceeds of the loans passed through a TOUSA subsidiary before going to the JV lenders.
  - When a lender is being paid millions from someone other than the debtor then some due diligence is expected.

Statutory Exceptions to Avoidance Power

Safe Harbors

- The Bankruptcy Code includes certain "safe harbors," within which transfers cannot be avoided as preferential or fraudulent.
- The one most relevant to the LBO context is the Section 546(e) safe harbor.
- Notably, this safe harbor explicitly does not apply to claims for actual fraudulent transfers.

546(e) Statutory Language

"Notwithstanding sections 544, 545, 547, 548(a)(1)(B) and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, . . . or 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, or that is a transfer 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, as defined in section 741(7), commodity contract, as defined section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title."

546(e) Language, in English

The trustee may not avoid a transfer that is:

- A settlement payment made by or to (or for the benefit of) … financial institution [or] financial participant …,

or

- A transfer made by or to (or for the benefit of) a … financial institution [or] financial participant … in connection with a securities contract

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Section 546(e) Interpretation

Judicial interpretation of 546(e) tends to fall into one of two camps:

- Statutory intent: Section 546(e) is a safe harbor intended to protect the integrity of the market; to reduce systemic risk to the markets that could result from undoing historic transactions upon which counter-parties had relied, had hedged, and had re-allocated proceeds.

- Strict Reading: The language, although arguably illogical and all encompassing, is not ambiguous, and therefore should be interpreted as written without reference to statutory intent.

Settlement Payment

- Bankruptcy Code Section 101: "The term 'settlement payment' means, for purposes of the forward contract provisions of this title, a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, a net settlement payment, or any other similar payment commonly used in the forward contract trade." (Bankruptcy Code Section 741: "any other similar payment commonly used in the securities trade.")

In re Appleseed's Intermediate Holdings, LLC, 470 B.R. 289 (D. Del. 2012)

- The Debtors entered into a $710 million credit facility to fund a $170 million acquisition, to retire some existing debt, and to make a $310 million dividend to private equity shareholders.
- Appleseed's filed for chapter 11 protection a few years later, and the committee sought to avoid the acquisition and the dividend as, among other things, fraudulent conveyances.
- The defendants moved to dismiss on the grounds that, among other things, the dividends to the defendants were protected by the safe harbor of section 546(e)
- The Court found that these dividends were not protected by 546(e) because there was no exchange of value. As such, the payments were not "settlement payments." As the Court explained:
  - "Although the Third Circuit has held that a payment for shares during a leveraged buyout is a settlement payment, … those transactions involved security exchanges. The necessary implication is that both parties exchanged some value."
  - The court went on to say that "the [acquisition] may fall within the meaning of settlement payment, [but] the [] acquisition cannot be conflated with the payment of the dividend."

Enron Creditors Recovery Corp. v. Alfa, S.A.B., de C.V., 651 F.3d 329 (2d Cir. 2011)

- Enron drew on its revolver to redeem its commercial paper prior to maturity.
- Payments were made to DTC, and then to investors through J.P Morgan. Defendants moved to dismiss based on 546(e).
- The Bankruptcy Court found that the payments at issue were not "settlement payments" because title to the commercial paper never changed hands. Because the debt was retired, not purchased, the Bankruptcy Court reasoned, the payments were not "settlement payments."
- The District Court reversed, and the 2d Circuit affirmed the District Court decision dismissing the complaint.
  - In addressing arguments raised by the plaintiffs, the Second Circuit found that the Phrase "commonly used in the securities trade" modifies only the final term in the definition (other similar payment), not the entire list of terms.
- Issues on 546(e)'s application in cases involving financial intermediaries may now be in question given the Supreme Court's 2018 *Merit Management* decision.

Financial Institution

The term “financial institution” means—

- (A) a Federal reserve bank, or an entity that is a commercial or savings bank, industrial savings bank, savings and loan association, trust company, federally-insured credit union, or receiver, liquidating agent, or conservator for such entity and, when any such Federal reserve bank, receiver, liquidating agent, conservator or entity is acting as agent or custodian for a customer (whether or not a “customer”, as defined in section 741) in connection with a securities contract (as defined in section 741) such customer; or
- (B) in connection with a securities contract (as defined in section 741) an investment company registered under the Investment Company Act of 1940.

Financial Participant

The term "financial participant" means—

- (A) an entity that, at the time it enters into a securities contract, commodity contract, swap agreement, repurchase agreement, or forward contract, or at the time of the date of the filing of the petition, has one or more agreements or transactions described in paragraph (1), (2), (3), (4), (5), or (6) of section 561(a) with the debtor or any other entity (other than an affiliate) of a total gross dollar value of not less than $1,000,000,000 in notional or actual principal amount outstanding (aggregated across counterparties) at such time or on any day during the 15-month period preceding the date of the filing of the petition, or has gross mark-to-market positions of not less than $100,000,000 (aggregated across counterparties) in one or more such agreements or transactions with the debtor or any other entity (other than an affiliate) at such time or on any day during the 15-month period preceding the date of the filing of the petition; or
- (B) a clearing organization (as defined in section 402 of the Federal Deposit Insurance Corporation Improvement Act of 1991).

Securities Contract

- Detailed definition, including:
  - A contract for the sale or purchase or loan of a security
  - Foreign currency options
  - Guarantee by or to any securities clearing agency of a settlement of cash
  - Margin loan
  - Extension of credit for the clearance or settlement of a securities transaction
  - Loan transaction coupled with a securities collar transaction, any prepaid forward securities transaction, or any total return swap transaction coupled with a securities sale transaction
  - Certain options, master agreements, security agreements or other credit enhancements, or any combination of the above

MERIT MANAGEMENT GROUP, LP V FTI CONSULTING, INC.

- Valley View Downs bought the equity of Bedford Downs for $55 million. Valley View financed the purchase through Credit Suisse in the Cayman Islands, and the parties used Citizens Bank as escrow agent for the transaction ($47.5 million released at closing, with the additional $7.5 million being released after the relevant holdback period passed). Merit Management was one of the equity holders of Bedford Downs, and received a total of $16.5 million.

- Bedford Downs ended up in bankruptcy, and FTI consulting was appointed as litigation trustee for the post-confirmation estate. It sued to recover the transfers as constructive fraudulent conveyances (i.e., Bedford Downs received less than reasonably equivalent value while it was insolvent), and Merit objected on the grounds that it was protected by the safe harbor of Section 546(e) by virtue of the transfers from Credit Suisse to Citizens, and from Citizens to the equity holders.

Merit Lower Court Decisions

- The Bankruptcy Court and District Court agreed with Merit, dismissing the claims.
- The 7th circuit reversed, holding that those intermediate transfers did not insulate the equity holders because the intermediate 'financial institutions' were just conduits, and held no beneficial interest in the proceeds.
- As a result, the 7th Circuit joined the 11 circuit in holding that mere conduits did not insulate transfers under 546(e). In contrast, 2nd, 3rd, 6th, and 8th circuits all held that it did not matter whether a transferee held any beneficial interest in a transfer, and that therefor even passing through a financial institution as a mere conduit insulates a transfer from avoidance.
- The Supreme Court granted cert to resolve the circuit split.

Merit, Supreme Court

138 S.Ct 883 (2018)

Unanimous opinion by Justice Sotomayor

- The Supreme Court affirmed the 7th Circuit
- "The court concludes that the plain meaning of §546(e) dictates that the only relevant transfer for purposes of the safe harbor is the transfer that the trustee seeks to avoid."
- As a result, because the trustee is seeking to avoid the transfer from Valley View to Merit Management, the intermediary steps through Credit Suisse and Citizens do not implicate the safe harbor of 546(e).

Merit, Supreme Court (cont'd)

- The Supreme Court did NOT address in Merit whether the transaction in question nonetheless qualified for the 546(e) exception by virtue of the definition of 'Financial Institution."
- Recall that "Financial Institution" includes a customer of a Federal reserve bank if that Federal reserve bank was acting as agent or custodian for such customer.
- Footnote 2 of the Supreme Court opinion expressly declares that the parties in that case did not contend that the petition qualifies as a financial institution because it is a "customer" of a financial institution, and the Court "therefore [did] not address what impact, if any, 101(22)(A) would have in the application of the 546(e) safe harbor."
- In fact, Justice Breyer specifically pointed to that language as a potentially huge loophole in this decision:
  - "And so why are we hearing this case? . . . when I look up the definition of financial institution, it says that not only is it Credit Suisse and not only is it Citizens Bank, but it is also the customers of each of those financial institutions in an instance where the bank is acting as agent or custodian for a customer."

CASES: Tribune/Section 546(e)

- In re Tribune Co. Fraud. Conveyance Lit., 818 F.3d 98 (2d Cir. 2016)
  - In 2007, Tribune Company board of directors approved an LBO to Sam Zell to take the company private
  - Tribune borrowed over $11B secured by its assets, Zell provided a $315M equity contribution, and Tribune used the funds to refinance its bank debt and cash out SHs at $8B (an amount above the per-share trading price).
  - Tribune transferred the $8B to a “securities clearing agency” or other “financial institution” as intermediaries in the LBO, who then paid the SHs.
  - Tribune’s creditors sought to avoid Tribune’s payments to the SHs:
    - Committee/Litigation Trust brought an action for intentionally fraudulent transfers; and
    - Retirees and (pre-LBO) Noteholders brought actions under state law for constructively fraudulent transfers (after two-year window closed).

CASES: Tribune/Section 546(e) (*cont'd*)

- District Court Holding (Retirees/Noteholders): (i) Automatic Stay barred litigation because the Litigation Trust was pursuing the avoidance of the same transfers, albeit under a different legal theory; and (ii) Section 546(e) does not preempt state-law constructive fraudulent conveyance claims. (*In re Tribune Co. Fraud. Conveyance Lit.*, 499 B.R. 310, 313 (S.D.N.Y. 2013).)
- Second Circuit: (i) Reversed: The Bankruptcy Court's Orders had lifted the automatic stay, and Tribune's confirmed plan allowed the Retirees/Noteholders to pursue the actions; and (ii) Reversed: Section 546(e) did preempt state-law claims. (*Id.* at 105.)
- Issue No. 2: The Second Circuit's reasoning was that allowing creditors to pursue state-law constructive fraudulent conveyance claims would undermine Congress's goal through Section 546(e) of protecting the securities markets: "markets in which certainty, speed, finality, and stability are necessary to attract capital" (*Id.* at 119).

CASES: Tribune/Section 546(e) (*cont'd*)

- Analysis for Preemption:
  - Federal law prevails when it conflicts with state law. Supremacy Clause, Art. VI, Clause 2. (*Id.* at 109.)
  - Presumption against preemption did not apply because "the regulation of creditors' rights has a history of significant federal presence." (*Id.* at 111.)
    - That is, there was no "measurable concern about federal intrusion into traditional state domains." Bankruptcy is a "wholesale preemption of state laws regarding creditors' rights" and the securities market are "subject to extensive federal regulation." (*Id.* at 111-12.)
  - Congress's intent: Section 544 (trustee as a creditor to pursue state law claims) is designed to "simplify proceedings, reduce the costs of marshalling the debtor's assets, and assure an equitable distribution among creditors." Section 546(e)'s use of the word "trustee" did not defeat this intent. (*Id*. at 115.)

CASES: Tribune/Section 546(e) (*cont'd*)

- There was no statutory basis for the argument that an estate's fraudulent claims "revert" to creditors after case closed or two-year statute of limitations has expired, although the Second Circuit did not resolve the reversion issue (*Id.* at 114, 117.)

- Retirees/Noteholders' arguments conflict with the purpose of Section 546(e): "Section 546(e) was intended to protect from avoidance proceedings payments by and to financial intermediaries in the settlement of securities transactions or the execution of securities contracts. . . . To allow [Retirees/Noteholders'] claims to proceed, we would have to construe Section 546(e) as achieving the opposite of what it was intended to achieve." (*Id*. at 119.)

- Affirmed dismissal of the state law fraudulent transfer complaint on preemption grounds

CASES: Tribune/Section 546(e) (*cont'd)*

Compare: In re Physiotherapy Holdings, Inc., 2016 WL 3611831 (Bankr. D. De.2016). Debtor issued $300 million in debt to finance the LBO, with the two controlling shareholders receiving $250 million. Bankruptcy followed and post-confirmation litigation trust sued former shareholders, who moved to dismiss arguing LBO payments were protected under 546(e). Trustee argued the safe harbor did not apply to state law claims and defendants responded that 546(e) preempted them. Bankruptcy Court disagreed, rejecting the *Tribune* analysis and adopting *Lyondell* reasoning:

-- 546(e) intended to prevent ripple effect of market participant's failure on market

-- Scope limited to financial institutions and not beneficial owners of securities, or ultimate recipients of transfers

-- textual support: 546(e) applied only to trustees; no express preemption (544(b)(2)

-- allegations of bad faith by SHs

CASES: Tribune/Section 546(e) (*cont'd)*

- Tribune Retiree/Noteholder Petition for *Certiorari* to the United States Supreme Court is pending, but in April 2018, two Justices issued a statement deferring consideration and asking the Second Circuit or District Court to "consider whether to recall the mandate . . . in light of this Court's decision in *Merit Management*."

- The Retirees/Noteholders moved before the Second Circuit to recall the mandate. The Second Circuit granted the relief on May 15, 2018: "It is hereby ordered that the mandate in this case is recalled in anticipation of further panel review." (ECF 13-3992, Doc. No. 387.)

- Possible impact of *Merit Management* on 546(e) preemption analysis

Potentially Conflicting Decisions in Madoff

- Although not in a LBO context, these cases address the applicability of the 546(e) safe harbor to avoidance actions.
- In both cases, the Madoff Trustee, Irving Picard, brought suits seeking to avoid transfers to various defendants as preferences and fraudulent conveyances, among other grounds.
- In both cases, the defendants sought to dismiss the complaints at the pleading stage based on, among other things, the safe harbor of 546(e).
- The two cases came down on seemingly opposite sides of the same question -- Judge Lifland, affirmed by Judge Wood, found 546(e) did not apply at the pleading stage.
- Judge Rakoff found 546(e) did apply, and dismissed a large portion of the claims brought by the Trustee

546(e) Does Not Apply to Madoff Litigation

- <u>Picard v. Merkin, et al.</u>, 440 B.R. 243 (Bank. SDNY 2010), affirmed,2011 WL 3897970 (S.D.N.Y. 2011)
  - "Section 546(e) provides an affirmative defense that, unless clearly established on the face of the Complaint, 'does not tend to controvert the [trustee's] prima facie case."
  - "Whether Madoff, through BLMIS, was a stockbroker 'engaged in the business of effecting transactions in securities' is dubious."
  - "even if BLMIS were a stockbroker, the Court questions whether the Account Agreements are securities contracts as that term is conceived by the statute."
  - "Courts have held that to extend safe harbor protection in the context of fraudulent securities scheme would be to 'undermine, not protect or promote investor confidence … [by] endorsing a scheme to defraud SIPC,' and therefore contradict the goals of the provision."
  - As a result, the court refused to dismiss the complaint at the pleading stage.

546(e) Does Apply to Madoff Litigation

- Picard v. Katz, et al., 1:11-cv-03605, September 27, 2011.
  - "Because Madoff Securities was a registered stockbrokerage firm, the liabilities of customers like the defendants here are subject to the 'safe harbor' set forth in section 546(e) of the Bankruptcy Code."
  - "all payments made by Madoff Securities to its customers" were "clearly" "settlement payments"
  - "Furthermore, any payment by Madoff Securities to its customers that somehow does not qualify as a 'settlement payment' qualifies as a 'transfer' made 'in connection with a securities contract.'"
  - As a result, the court dismissed all counts of the complaint, other than those predicated on actual fraud or equitable subordination.
  - Initial motion for leave to appeal was denied, and case was settled on March 19, 2012.