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Failed LBOs, Recovering Payments To Shareholders

Law360, New York (January 13, 2009) -- As the financial crisis continues to work its way through the economy, we will likely see failed leveraged buyouts increasingly scrutinized by unsecured creditors committees in an effort to maximize the recovery to their constituents.

As such, this is a good opportunity to review the implications of the 11 U.S.C. § 546(e) (Title 11) for the efforts by committees to recover payments to shareholders from an LBO as constructive fraudulent transfers.

LBOs In General

In its simplest terms, an LBO is a transaction in which a target company is acquired using borrowed money secured by liens on the assets of the target company[1] to purchase the target's shares from the old equity holders.[2] An LBO encumbers the assets of the target company for the benefit of its shareholders. This is not necessarily to the benefit of the target company itself.

If the target of an LBO fails, parties may initiate fraudulent transfer litigation to (1) avoid the liens granted to third party lenders involved in the LBO and (2) recover the payments made to the target company's former shareholders when they cashed out their equity positions.[3]

The argument usually is that the LBO transaction resulted in transfers from the target company, either in the form of liens or cash payments, which were not in exchange for reasonably equivalent value.[4]

The Impact Of Section 546(e)

Section 546(e) may provide a defense against the potential litigation discussed above. It states:

(e) 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, as defined in section 101,743, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to a

commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, that is made before the commencement of the case, except under section 548(a)(10(A) of this title.

Congress enacted Section 546(e) "to minimize the displacement caused in the commodities and securities market in the event of a major bankruptcy affecting those industries. Munford v. Valuation Research Corporation (In the Matter of Munford Inc.), 98 F.3d 604, 609 (11th Cir. 1996) (quoting from H. R. Rep. No. 97-420, 97th Cong., 2d Sess. 1 (1982), U.S. Code Cong. and Admin. News 583).

Congress also sought to promote customer confidence in the commodity and securities markets by protecting commodity and security market stability. Kaiser Steel Corp. v. Charles Schwabb & Co., 913 F.2d 846, 849 (10th Cir. 1999); Munford, 98 F.3d at 609; Sen. R. No. 989, 95th Cong., 2d Sess. 8 (1978).

In order for Sections 546(e) to apply, the defendant must establish: (1) the payment to the defendant was a "margin payment" or "settlement payment"[5]; (2) the payment was made to or from one of the institutions listed in Section 546(e) and (3) the payment was not made with the intent to defraud creditors. Loranger Manufacturing Corp., et al., v. PNC Bank, et al., In re Loranger Manufacturing Corporation), 324, B.R. 575, 584 (Bankr. W. D. P. 2005).

A Split In The Courts

An interesting split, however, exists in the courts regarding the applicability of Section 546(e) to payments to a shareholder made via wire transfer from the target's bank account at a financial institution.[6]

On of one hand, there are so-called conduit line decisions, such as the Eleventh Circuit's ruling in Munford. In that case, the acquiring company agreed to purchase all of the debtor's stock with proceeds from a loan secured by the debtor's assets.

The cash needed to fund the payments to the shareholders was placed on deposit at Citizens Southern Trust Company. Once the shareholders tendered the shares to Citizens, it released the funds to the shareholders.

After the debtor filed for bankruptcy, it filed suit against the shareholders seeking to recover the payment as constructive fraudulent transfers.

The shareholders filed motions for summary judgment arguing that Section 546(e) prevented the recovery of the funds as constructive fraudulent transfers because they were settlement

payments made by a financial institution (i.e. Citizens). The trial court granted the shareholders motion for summary judgment.

The Eleventh Circuit reversed and held that Section 546(e) was not applicable because the payments were made by the debtor to the shareholders and not by any of the entities listed in Section 546(e). Munford, 98 F.3d at 610. The court explained:

True, a section 546(e) financial institution was presumptively involved in this transaction. But the bank here was nothing more than an intermediary or conduit. Funds were deposited with the bank and when the bank received the shares from the selling shareholders, it sent funds to them in exchange. The bank never acquired a beneficial interest in either the funds or the shares.

Importantly, a trustee may only avoid a transfer to a "transferee." See 11 U.S.C.§ 550. Since the bank never acquired a beneficial interest in the funds, it was not a "transferee" in the LBO transaction. See In re Chase & Sanborn Corp., 848 F.2d 1196, 1100 (11th Cir. 1988) ("When banks receive money for the sole purpose of depositing it into a customer's account ... the bank never has actual control of the funds and is not a § 550 transferee").

And, of course, section 546(e) offers no protection from the trustee avoiding powers to shareholders; rather, section 546(e) protects only commodity brokers, forward contract merchants, stockbrokers, forward contract merchants, stockbrokers, financial institutions and securities clearing agencies.

Accordingly, regardless of whether the payments qualify as settlement payments, section 546(e) is not applicable since the LBO transaction did not involve a transfer to one of the listed protected entities. We conclude that the district court erred with respect to this issue and reverse. Munford, 98 F.3d at 610.

On the other hand, there are cases such as Loranger Manufacturing Corporation, et al. v. PNC Bank, National Association, et al. (In re Loranger Manufacturing Corporation), 324 B.R. 575 (Bankr. W.D. Pa. 2005).

In Loranger, the debtor borrowed money from PNC Bank and then paid a portion of the proceeds via wire transfer from the debtor’s bank account to one of the shareholders to redeem his shares of stock. After filing for bankruptcy, the debtor sued the shareholder to recover the payment as a constructive fraudulent transfer.

The shareholder filed a motion for summary judgment, arguing that Section 546(e) prevented the avoidance of the payment. The trial court granted the shareholder's motion.

The court focused on the fact that the payment was made by wire transfer, and as such was made by a financial institution. The court noted that debtor directed PNC to make a wire transfer for the shareholder's benefit.

Since the wire transfer was performed by the bank, Section 546(e) prevented the court from avoiding the transfers as constructive fraudulent transfers.

See, also: Lowenschuss v. Resorts International Inc. (In re Resorts International Inc., 181 F.3d 505, 515 13d Cir. 1999); Brandt v. B.A. Capital Company LP, et al. (In re Plassien International Corporation, 366 B.R. 318, 323 (Bankr. D. Del. 2007); Official Committee of Unsecured Creditors v. Fleet Retail Finance Group, et al. (In re Heckenger Investment Co. of Delaware), 274 B.R. 71 (De. Del. 2002).

In Loranger and subsequent decisions that interpret Section 546(e) along the same lines, the exception swallows the constructive fraudulent transfer rule.

In these cases, the debtor directs the bank to make a wire transfer from its bank account to a shareholder to complete the purchase of securities. Because the money was paid by a bank through a wire transfer, these courts hold that Sec. 546(e) prevents the transfer from being avoided.

While no reported decisions address the issue of payment by forms other than wire transfer, a natural extension of the Loranger decision is that any payment made from an account at a financial institution (check, cashiers check, etc.) would not be subject to avoidance due to Sec. 546(e).

Indeed, based on the Loranger view of Section 546(e), the only way payments to shareholders pursuant to an LBO would be subject to constructive fraudulent transfer risk is if the settlement payment was made with cash.

When comparing the above-mentioned rulings, it can be said that the Eleventh Circuit's decision in Munford most closely follows what Congress intended for Sec. 546(e). As the Mumford court noted, Sec. 546(e) was not enacted to prevent the recovery of transfers to shareholders. Indeed, the statute was only intended to protect the intermediaries in the financial system.

As a result in the inconsistent decisions by the courts relating to the Sec. 546(e) defense, counsel for potential debtors arising out of failed LBOs need to include in there analysis an evaluation of the ramification of these decisions on their choice of venue.

If the debtor arising out of the failed LBO is heading straight into liquidation, a decision to choose a venue that provides an expansive reading of Sec. 546(e) may result in the loss of a potentially valuable cause of action for the estate and a significantly reduced recovery for unsecured creditors.

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[1] Economics A-Z, www.economist.com/research/Economics/.

[2].See, e.g., Weiboldt Store v. Schottenstein, 94 B.R. 468, 493 (N.D. Ill. 1988).

[3] See, Id.

[4] Pursuant to 11 U.S.C. § 548(a)(1)(B), a "constructive" fraudulent transfer can be avoided if (1) the debtor received less than reasonably equivalent value in exchange for the transfer and (2) the debtor was insolvent or rendered insolvent as a result of the transfer.

[5] For purposes of this article, a “settlement payment” will be any payment made to a shareholder to complete a securities transfer including the purchase of shares of stock. See, Sec. 741(8); Elway Company LLP v. Miller (In re Elrod Holdings Corp.), __ B.R. ___, 208 WL 4414315 (Bankr. D. Del., Sept. 30, 2008).

[6] While many issues arise in the context of Section 546(e), this article is limited to the issue of whether a payment from the debtors bank account qualifies as a "transfer" from a financial institution under Section 546(e).

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