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Panel 2: Limits on Leverage (Fraudulent Transfer etc.)

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Topics for Discussion:

1) Section 546(e) of the Bankruptcy Code—Limits to the Safe Harbor?

2) Intentional Fraudulent Transfers—Whose Intent Matters?

3) Valuation—What Is the Role of Marketplace Evidence?

4) Savings Clauses—Useful Tool or "Too Cute to Be Enforced"?

1) Section 546(e) of the Bankruptcy Code—Limits to the Safe Harbor?

a) Does Section 546(e) Protect Transfers Where Financial Institution Is a "Mere Conduit"?[1]

i) Seventh Circuit:[2] *FTI Consulting, Inc. v. Merit Mgmt. Grp., LP*, 830 F.3d 690 (7th Cir. 2016)(section 546(e) does not protect "transfers that are simply conducted *through* financial institutions (or the other entities named in section 546(e)), where the entity is neither the debtor nor the transferee but only the conduit.")[3]

a. Focus on economic substance of transaction.

b. No "systemic risk in the financial marketplace" if such transfers are not protected.

ii) Second Circuit[4] *In re Quebecor World (USA) Inc.*, 719 F.3d 94 (2d Cir. 2013) (safe harbor applicable where financial institution was trustee and actual exchange was between two private entities).

a. Statute is unambiguous: "a transfer may be either 'for the benefit of' a financial institution or 'to' a financial institution, but need not be both."

b. Any transaction involving financial institutions as intermediaries, even if they are "conduits," should be protected.

c. ***But consider recent case***: *In re TVGA Eng'g, Surveying, P.C.,* 562 B.R. 862, 865 (Bankr. W.D.N.Y. 2016) ("If the Debtor had bought money orders from the local, closely-held supermarket chain, and Mr. Pahel had cashed them at his

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[1] Section 546(e) provides that "the trustee may not avoid a transfer that is a margin payment … or settlement payment … 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 … commodity contract … or forward contract"" 11 U.S.C. § 546 (emphasis added).

[2] The Eleventh Circuit has also held that section 546(e) did not protect LBO because ultimate recipients of transferred funds were not protected entities. *See In re Munford*, 98 F.3d 604 (11th Cir. 1996).

[3] On appeal to Supreme Court of the United States (No. 16-784, petition pending).

[4] The Third, Sixth, Eighth, and Tenth Circuits have held the same. *See Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 987 (8th Cir. 2009); *In re QSI Holdings, Inc.*, 571 F.3d 545, 551 (6th Cir. 2009); *In re Resorts Int'l, Inc.*, 181 F.3d 505, 516 (3d Cir. 1999); *In re Kaiser Steel Corp.*, 952 F.2d 1230, 1240 (10th Cir. 1991).

local store in the same chain, § 546(e) could not possibly apply. The avoidability of … transfers, to benefit the Debtor's other creditors, cannot be permitted to turn upon the use of a bank, rather than a supermarket chain, as the vehicle for transferring what otherwise would be a cash payment.")

b) **Does Section 546 Preempt State Law Fraudulent Transfers Claims?**

i) *In re Tribune Company Fraudulent Conveyance Litigation*, 818 F.3d 98 (2d Cir. 2016):

a. Presumption against preemption is inapplicable in bankruptcy cases because, "[o]nce a party enters bankruptcy, the Bankruptcy Code constitutes a wholesale preemption of state law regarding creditors' rights." *Id.* at 111.

b. Section 546(e) was intended to protect investors from the disruptive effect of unwinding securities transactions and allowing creditors to bring state fraudulent transfer claims in connection with a debtor would undermine this protection.

ii) *Whyte v. Barclays Bank PLC*, 494 B.R. 196, 200 (S.D.N.Y. 2013), *aff'd*, 644 F. App'x 60 (2d Cir. 2016):

a. "[S]afe harbor prohibiting a bankruptcy trustee from avoiding transfers made in connection with a swap transaction (*see* 11 U.S.C. § 546(g)) implicitly preempts state law fraudulent transfer claims by individual creditors of a debtor that declared bankruptcy even if bankruptcy trustee chose not to bring such claims."

iii) ***But Consider***: *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994)

a. "To displace traditional state regulation in such a manner, the federal statutory purpose must be clear and manifest. Otherwise, the Bankruptcy Code will be construed to adopt, rather than displace, pre-existing state law." *Id.* at 544-45.

iv) *In re Physiotherapy Holdings, Inc.,* No. 13-12965(KG), 2016 WL 3611831, at *5 (Bankr. D. Del. June 20, 2016) (rejecting *Tribune*).

a. "The issue therefore is straightforward: would allowing the Litigation Trust to pursue its state fraudulent transfer claims have a destabilizing effect on the financial markets Congress sought to protect? The Court believes the answer is clearly no." *Id.* at *9.

b. “[S]ection 546(e) only limits a *trustee's* ability to bring a fraudulent conveyance action.” *Id.*

2) Intentional Fraudulent Transfers—Whose Intent Matters?

a) **Second Circuit Split—Can Intent of Officers Be Imputed to Corporation?**

i) *In re Lyondell Chem. Co.*, 554 B.R. 635 (S.D.N.Y. 2016) (reversing *In re Lyondell Chem. Co.*, 541 B.R. 172 (Bankr. S.D.N.Y. 2015))

a. "[T]he knowledge and actions of [a] corporation's officers and directors, [if] acting within the scope of their authority, are imputed to the corporation itself." *Id.* at 649.

b. The Lyondell court relied heavily on principles of Delaware agency law, and noted that other courts' decisions that evaluate whether the officer had the ability to control the company's decision makers did not focus the nature of the officer's employment or address "the general rule under Delaware agency law" that an officer's knowledge and actions are imputed to their company when acting within the scope of their authority.

ii) *In re Tribune Co. Fraudulent Conveyance Litig.*, No. 11-MD-2296 (RJS), 2017 WL 82391, at *6 (S.D.N.Y. Jan. 6, 2017)

a. An officer's conduct can only be imputed to its employer for purposes of establishing a claim for actual fraudulent conveyance when the officer is "***in a position to control the disposition of [the transferring entity's] property, thereby effectuating the underlying offense***."

b. "Although former U.S. Bankruptcy Judge Gerber's thoughtful opinions in Lyondell were recently overturned on appeal by Judge Cote in *Lyondell III*, 554 B.R. at 635, that opinion is not binding on this Court. Indeed, the Court finds Judge Gerber's analysis to be highly compelling and, for the reasons set forth in this section, the Court continues to apply Judge Gerber's analysis as persuasive, though obviously not binding, authority."

3) Valuation—What Is the Role of Marketplace Evidence?

a) Financial Condition Tests

i) Insolvency: Balance Sheet Test

a. "'Insolvent' is defined by the Code as a 'financial condition such that the sum of [the] entity's debts is greater than all of [the] entity's property, at a fair valuation….'" *In re Roblin Indus., Inc.*, 78 F.3d 30, 35 (2d Cir. 1996) (quoting 11 U.S.C. § 101(32)).

b. But the balance sheet is only the starting point of the balance sheet test. *See In re Trans World Airlines, Inc.*, 180 B.R. 389, 405 n. 22 (Bankr. D. Del. 1994); *In re Iridium Operating LLC*, 373 B.R. 283, 344 (Bankr. S.D.N.Y. 2007) (citing *In re Roblin Indus., Inc.*, 78 F.3d 30, 38 (2d Cir. 1996)) (Courts "should consider the totality of the circumstances.").

   i. ***Valuation Date***: Date of Transfer. *See, e.g.*, *Iridium*, 373 B.R. at 346 (collecting cases demonstrating that relevant inquiry is insolvency as of the transfer date).

   ii. ***Value***: "fair value"; "going concern"; "market price." *See In re Iridium Operating LLC*, 373 B.R. 283, 344 (Bankr. S.D.N.Y. 2007) (citing *In re Roblin Indus., Inc.*, 78 F.3d 30, 35 (2d Cir. 1996)) ("determined by the fair market price of the debtor's assets that could be obtained if sold in a prudent manner within a reasonable period of time to pay the debtor's debts.").

      - Actual Sale Price
      - Discounted Cash Flow
      - Adjusted Balance Sheet
      - Market Multiple Approach
      - Comparable Transactions
      - Market Capitalization

   iii. ***Value of Liabilities***: Courts ***generally*** use the face value of debt rather than publicly traded market value. *See, e.g.*, *In re Winstar Comm'ns, Inc.*, 348 B.R. 234, 278 (Bankr. D. Del. 2005); *but see In re Fidelity Bond and Mortg. Co.*, 340 B.R. 266, 289 (E.D. Pa. 2006) ("In an effort to determine the fair market valuation of the Debtor's assets and liabilities, both experts made various adjustments to the balance sheet line items to arrive at their … conclusions …")

ii) **Unreasonably Small Capital**

a. Even if a debtor was not insolvent under the balance sheet test, a transfer or obligation may nonetheless be avoidable if the transfer was made or obligation was incurred when the debtor "was engaged in a business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital." 11 U.S.C. § 548(a)(1)(B)(II).

i. Courts compare company's projected cash inflows (also referred to as "working capital" or "operating funds") with the company's capital needs throughout a reasonable period of time after the questioned transfer. *Iridium*, 373 B.R. at 345 (citing *Moody*, 971 F.2d at 1071-72).

ii. Only those cash inflows that were reasonable for a company to have expected to receive, whether through new equity, cash from operations, or available credit are considered in this analysis. *Id.* (citing *Moody*, 971 F.2d at 1072 n. 24, 1073).

iii. But, as Judge Posner points out, "one has to be careful with a term like 'unreasonably small,'" as it is "fuzzy, and in danger of being interpreted under the influence of hindsight bias. One is tempted to suppose that because a firm failed it must have been inadequately capitalized. The temptation must be resisted." *Boyer v. Crown Stock Distribution, Inc.*, 587 F.3d 787, 794 (2009).

iii) **Inability to Pay Debts as They Come Due (Equitable Insolvency)**

a. If a debtor was neither insolvent under the balance sheet test nor was left with unreasonably small capital after the transfer, a transfer or obligation may nonetheless be avoidable if the debtor "intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured." 11 U.S.C. § 548(a)(1)(B)(III).

b. This test is largely moot because equitable insolvency is a more severe financial condition than unreasonably small capital. *Moody v. Security Pacific Business Credit, Inc.*, 971 F.2d 1075 (3d Cir. 1992) ("Because we assume the notion of unreasonably small capital denotes a financial condition short of equitable insolvency, it follows that the transaction did not render Jeannette equitably insolvent either.”).

c. Plaintiffs sometimes even omit equitable insolvency as an allegation altogether. *See, e.g.*, *Peltz v. Hatten*, 279 B.R. 710, 742 (Bankr. D. Del. 2002) (parties’ dispute on insolvency focuses on the first two tests because Trustee does not allege inability to pay debts as they come due).

b) **Role of Marketplace Evidence**

i) Because valuation is largely subjective, courts defer to prevailing marketplace values rather than hindsight valuations. *In re Hechinger Investment Co. of Del.*, 327 B.R. 537, 548 (D. Del. 2005); *see also Iridium*, 373 B.R. at 346 (noting that contemporaneous market evidence has “the advantage of … being untainted by hindsight or post-hoc litigation interests). Courts consider the following:

a. **Stock Price**. *See Iridium*, 373 B.R. at 346; *Metlyn Realty Corp. v. Esmark, Inc.*, 763 F.2d 826, 835 (7th Cir. 1985).

b. **Management Projections and Views**. *See Iridium*, 373 B.R. at 348 (“When there is substantial evidence presented to show that the business plan was prepared in a reasonable manner, using supportable assumptions and logically consistent computations, a business plan constitutes a fair, reasonable projection of future operations and alternative projections of future operations should be rejected.”)

c. **Views of Analysts and Private Investors**. *See Iridium*, 373 B.R. at 348 (“Expert analysis by investment bankers that confirms the validity of management’s projections is an indicator of reasonableness.”)

ii) ***Consider***: What about unforeseen events?

a. The law does not require that companies be sufficiently well capitalized to withstand any and all setbacks to their business. The requirement is only that they not be left with “unreasonably small capital” ***at the time of the conveyance*** alleged as fraudulent. *Credit Managers Ass'n of Southern California v. Federal Co.*, 629 F.Supp. 175, 187 (C.D.Cal. 1985); *see also MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport*, 910 F. Supp. 913, 944 (S.D.N.Y. 1995); *Moody v. Sec. Pac. Bus. Credit, Inc.*, 971 F.2d 1056, 1071 (3d Cir. 1992).

4) **Savings Clauses— Useful Tool or "Too Cute to Be Enforced"?**

a) *In re TOUSA, Inc.*, 422 Bankr. 783 (Bankr. S.D. Fla. 2009), *quashed in part*, 444 B.R. 613 (S.D. Fla. 2011), *aff'd in part, rev'd in part*, 680 F.3d 1298 (11th Cir. 2012).

i) Loan agreements included the following savings clause:

> "Each Borrower agrees if such Borrower's joint and several liability hereunder, or if any Liens securing such joint and several liability, would, but for the application of this sentence, be unenforceable under applicable law, such joint and several liability and each such Lien shall be valid and enforceable to the maximum extent that would not cause such joint and several liability or such Lien to be unenforceable under applicable law, and such joint and several liability and such Lien shall be deemed to have been automatically amended accordingly at all relevant times." *Id.* at n. 49.

ii) "Savings clause" is unenforceable.

> "If the Conveying Subsidiaries became insolvent only after the July 31 Transaction, the savings clauses are unenforceable under 11 U.S.C. § 541(c)(1)(B), which provides that an interest of the debtor in property becomes property of the estate, notwithstanding any "provision in an agreement" that is "conditioned on the insolvency or financial condition of the debtor" that "effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property." The savings clauses are "provision[s] in an agreement." They are "conditioned on the insolvency or financial condition of the debtor." And they "effect a forfeiture, modification, or termination of the debtor's interest in property." In particular, the savings clauses, if given the effect claimed by Defendants, would defeat the debtors' cause of action for a fraudulent transfer, and a cause of action is unquestionably property of the debtor." *Id.* at 863.

> "[T]he only purpose served by the savings clauses is to ensure that the transferee can preserve its claim to every last penny of the debtor's remaining assets without providing reasonably equivalent value. The savings clauses are a frontal assault on the protections that section 548 provides to other creditors. They are, in short, entirely too cute to be enforced." *Id.* at 864.

b) ***Consider:*** Douglas G. Baird, *One-and-A-Half Badges of Fraud*, Prac. Law., August 2014