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Private Leveraged Buyouts, Fraudulent Transfers and FTI Consulting

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Leveraged buyouts ("LBOs") are acquisitions in which the assets of the target are pledged as collateral for loans used to fund the buyouts of the target's shareholders. If the target subsequently fails, the LBOs may be subject to avoidance as fraudulent transfers because the target's shareholders were paid before its creditors. Parties attacking LBOs rely upon section 548 of the United States Bankruptcy Code,[1] which provides that transfers by an entity made for less than reasonably equivalent value and (1) made while the entity is insolvent (or which cause the entity to become insolvent), (2) which leave the target with unreasonably small capital, or (3) which the target knows or should have known will cause the target to be unable to pay its debts as they became due, are avoidable as fraudulent transfers. Transfers made up to two years prior to the filing of the bankruptcy petition are avoidable under Code section 548. Parties attacking LBOs also rely upon Code section 544, which allows the trustee to utilize applicable law, including the Uniform Fraudulent Transfer Act (the state law analog to Code section 548), to avoid transfers made usually up to four years prior to the filing of the bankruptcy petition.[2]

However, Code section 546(e) provides that, notwithstanding Code sections 548 or 544, "settlement payments" (including payments made in connection with the sale of securities)[3] made by or to (or for the benefit of) a "financial institution" (including a commercial bank)[4] are not avoidable as fraudulent transfers. The statute creates a safe harbor which on its face seems to broadly insulate from fraudulent transfer attack sales of securities where payment is "made by or to a financial institution." The rationale for Code section 546(e) is to prevent systemic risk to the financial markets caused by "one large bankruptcy from rippling through the securities industry."[5]

But what about LBOs pursuant to which the shareholders of a closely held corporation receive payments comprised of leveraged loan proceeds from a commercial bank which acts as a mere conduit for the purchase price paid by the target's purchasers? Reading the statute literally, the Second,[6] Eighth,[7] Sixth,[8] Third[9] and Tenth[10] Circuit Courts of Appeal have strictly applied the Code section 546(e) safe harbor to insulate private transactions involving "settlement payments" which were made "by or to a financial institution" from fraudulent transfer avoidance.

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Only the Eleventh Circuit[11]—and now the Seventh Circuit, in the recent decision of *FTI Consulting, Inc. v. Merit Management Group, LP*[12]—have ruled that the Code section 546(e) safe harbor does not apply to protect from fraudulent transfer attack private LBOs where payments are made through a financial institution acting as a mere conduit.

FTI involved two competitors, Bedford Downs and Valley View Downs, who desired to obtain licenses to operate "racinos" (a combination of harness racing tracks and casinos) in Pennsylvania. Rather than compete for the license, the competitors combined—one competitor purchased all of the shares of the other in a $55 million leveraged buyout. Payment for the shares was made through Citizens Bank of Pennsylvania, acting as escrow agent. However, when the required licenses were not granted, the combined entity filed a Chapter 11 petition. As trustee of a Chapter 11 litigation trust, FTI Consulting sued defendant Merit Management (which received $16.5 million of the $55 million purchase price) under Code sections 544 and 548. Merit argued that the Code section 546(e) safe harbor shielded it from liability. When the district court agreed and granted judgement on the pleadings to Merit under Federal Rule of Civil Procedure 12(c), FTI appealed.

The Seventh Circuit analyzed the meaning of Code section 546(e) and found it to be ambiguous. The court noted that when a party sends a postcard in the U.S. Mail, it could be said that the postcard was sent "by" the sender or "by" the U.S. Postal Service. When a customer makes a payment via an electronic bank transfer, the payment could be said to be made "by" the owner of the account or "by" the bank. Similarly, when a transfer is made through a financial intermediary, it could be said to be made "by or to" the financial institution or "by or to" the party receiving the funds. The plain language of Code section 546(e) does not clarify the ambiguity in this case, and, said the court, "standing alone, does not point us in one direction or the other."[13]

In Chapter 5 of the Code, sections 544, 547 (dealing with preferential transfers) and 548 address the types of transfers which a bankruptcy trustee can avoid. Code section 546(e) puts limitations on those avoidance powers. FTI argued that because only Chapter 5 transfers made by the debtor prepetition can be avoidable, a named entity in Code section 546(e) (such as a financial institution) ought also to refer to a transfer of property by the debtor, as opposed to a financial intermediary. Additionally, because Code sections 544, 547 and 548 refer to avoidance of transfers to or for the benefit of entities subject to fraudulent transfer liability, Code section 546(e) must refer only to transfers made to a named entity that is a creditor, rather than a non-stakeholder financial intermediary. The court agreed, saying that Chapter 5 creates a system of avoiding transfers and a safe harbor from avoidance—two sides of the same coin. It therefore makes sense to understand the safe harbor as applying to transfers that are eligible for avoidance in the first place.[14]

The court also agreed with FTI that Code sections 548(a)(2) and 555 support its argument. Code section 546(a)(2) shields from avoidance charitable contributions made "by a natural person" "to a qualified" charity. FTI argued that Code sections 548(a)(2) and 546(e) should be read consistently. Otherwise, charitable contributions made by wire transfer or check through a bank would be avoidable. Code section 555 permits counterparties to a securities contract with the debtor to enforce *ipso facto* provisions in the contract despite Code section 365(e)'s general prohibition on the enforcement of such provisions. Because Code section 555 focuses on the economic substance of the transaction and only applies where the named entity is a counterparty rather than a conduit or bank for a counterparty, Code section 546(e)'s safe harbor should apply in the same manner. It is the economic substance of the transaction, said the court, that matters.[15]

The court next addressed the concept of "transferee" under Code section 550, which describes how a trustee is to recover avoidable transfers. Under Code section 550, the trustee may avoid transfers received by immediate or mediate transferees (subject to a defense absolving an immediate or mediate transferee who takes in good faith and without knowledge of the voidability of the transfer). The court discussed its prior decision in *Bonded Financial,*[16] wherein it defined "transferee" as an entity with "dominion over the money" or "the right to put the money to one's own purposes."[17] In that case, the court found that a bank which "acted as a financial intermediary" and "received no benefit" was not a "transferee" within the meaning of Code section 550.[18] The court acknowledged that *Bonded Financial* did not address Code section 546(e), but specifically extended *Bonded Financial*'s reasoning to apply to transfers involving Code section 546(e).[19] In doing so, it rejected Merit's arguments that *Bonded Financial* was distinguishable because it dealt with Code section 550 rather than Code section 546(e). While Code section 546(e) renders a transfer unavoidable and Code section 550 provides a good faith defense, the court found no reason why unavoidability provisions should be broader than defenses to recovery. Rather, said the court, the opposite should be true.[20]

The court turned to the history of Code section 546(e), the purpose of which was to "'protect [ ] the market from systemic risk and allow [ ] parties in the securities industry to enter into transactions with greater confidence'—to prevent 'one large bankruptcy from rippling through the securities industry.'"[21] Although the scope of Code section 546(e) is broad, the court indicated that does not mean there are no limits.[22] The court was not troubled by the prospect of Merit's returning the funds to FTI causing such a disruptive impact. Consequently, it refused to interpret the Code section 546(e) safe harbor as covering any transaction involving securities that uses a financial institution or other entity enumerated in the statute as a mere conduit.[23]

The court acknowledged that its decision differed from five other circuits' and agreed with only one, the Eleventh. Like the Eleventh Circuit, the court held that Code section 546(e) is inapplicable where the principal parties are not the type of entities enumerated in the statute, and where the financial institution involved acts only as a conduit. The court further observed that if Congress had intended to say that acting as a conduit for a transaction between two entities not otherwise covered by Code section 546(e) is enough to trigger the statute, it could have done so.[24]

This decision is an important one for transactions involving leveraged buyouts between two private companies operating outside the public securities markets. The court's conclusion that using a non-stakeholder financial institution as a conduit is insufficient to trigger the exception appears to be correct. This is particularly true in light of the reasons why Code section 546(e) was added to the Code. However, the statute on its face makes no distinction between financial institutions having a stake in the LBO and those which act as a mere conduit. Given the circuit split, this seems like an issue bound for the United States Supreme Court, whose decision may depend upon the make-up of the Court at the time it takes the issue up.[25]

[1] 11 U.S.C. §§ 101 1532 (hereinafter the "Code").

[2] Some states, such as New York, are governed by the Uniform Fraudulent Conveyance Act, which has a statute of limitations of six years. In a very recent decision, *Mukamal v. Citibank, N.A. (In re Kipnis),* 555 B.R. 877 (Bankr. S.D. Fla. 2016), the bankruptcy court found that where the Internal Revenue Service is a creditor, "applicable law" includes the Internal Revenue Code, and a trustee asserting a claim under Code section 544(b) is not bound by state statutes of limitation.

[3] *See* 11 U.S.C. § 741.

[4] *See* 11 U.S.C. § 101(22).

[5] *See Grede v. FCStone, LLC,* 746 F.3d 244, 252 (7th Cir. 2014).

[6] *See In re Quebecor World (USA) Inc.*, 719 F.3d 94 (2d Cir. 2013).

[7] *See Contemporary Indus. Corp. v. Frost,* 564 F.3d 981 (8th Cir. 2009).

[8] *See In re QSI Holdings, Inc.*, 571 F.3d 545 (6th Cir. 2009).

[9] *See In re Resorts Int'l. Inc.*, 181 F.3d 505 (3d Cir. 1999).

[10] *See In re Kaiser Steel Corp.*, 952 F.2d 1230 (10th Cir. 1991).

[11] *See In re Munford, Inc.*, 98 F.3d 604 (11th Cir. 1996).

[12] *See FTI Consulting, Inc. v. Merit Mgmt. Grp., LP*, 830 F.3d 690 (7th Cir. 2016).

[13] *Id.* at 692 693.

[14] *Id.* at 694.

[15] *Id.* at 695.

[16] *Bonded Fin. Servs., Inc. v. European Am. Bank,* 838 F.2d 890 (7th Cir. 1988).

[17] *Id.* at 893.

[18] *Id.*

[19] *FTI Consulting*, 830 F.3d at 695.

[20] *Id.*

[21] *Id.* at 696 (quoting *Grede v. FCStone, LLC,* 764 F.3d 244, 252 (7th Cir. 2014)).

[22] *Id.*

[23] *Id* at 697.

[24] *Id*.

[25]A petition for certiorari arising out of the Second Circuit's decision in the *Tribune* Chapter 11 regarding Code section 546(e) was filed on September 9, 2016.

See Deutsche Bank Tr. Co. Ams. v. Large Private Beneficial Owners (In re Tribune Co.), 818 F.3d 98 (2d Cir. 2016) (petition for cert. pending, No. 16 317 (filed Sept. 9, 2016)).