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Leveraged Buyout Transactions Under Heightened Scrutiny in Bankruptcy

Withstanding Creditor Challenges to Fraudulent Transfer Claims

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

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Leveraged Buyout Transactions Under Heightened Scrutiny In Bankruptcy – Withstanding Creditor Challenges to Fraudulent Conveyance Claims

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Fraudulent Transfers in LBOs

- **In bankruptcy, a debtor may seek to unwind certain transfers or obligations it believes were fraudulently made.**
- **In the LBO context, courts have permitted avoidance of two distinct parts of the LBO transaction:**
  - **debt incurred by the target company to fund the LBO and the liens granted to secure these obligations; and**
  - **payments made to the target company's former shareholders in exchange for equity or assets sold in the LBO.**

Fraudulent Transfers Under Applicable Law

- **Section 548 of the Bankruptcy Code allows for the avoidance of transfers made or obligations incurred within 2 years of the filing of the bankruptcy petition that are determined to have been fraudulent.**
- **Section 550 of the Bankruptcy Code provides that the debtor or chapter 11 trustee (whoever is acting as plaintiff) may recover from the transferee fraudulently transferred property, subject to certain limitations.**
- **Section 544 of the Bankruptcy Code also allows the debtor or trustee to avoid fraudulent claims under applicable non-bankruptcy law.**
  - **The majority of states (including NY and DE) employ the Uniform Fraudulent Transfer Act (UFTA), which is nearly identical to the Bankruptcy Code provisions, though states typically provide a 4-year or longer "claw back" period.**

Standards of Fraud

- There are two types of fraud for purposes of fraudulent transfer law: actual fraud and constructive fraud.
- Actual fraud exists where a transfer was made with actual intent to hinder, delay or defraud creditors.
  - Courts rarely, if ever, find actual fraud in the case of a market LBO.
- Constructive fraud is intended to deal with transfers that were not in the best interests of the transferor.
- Elements of constructive fraud:
  - The debtor received less than reasonably equivalent value in exchange for the transfer or obligation; and
    - was insolvent at the time or became insolvent as a result of such transfer or obligation;
    - was left with unreasonably small capital;
    - intended to incur, or believed debtor would incur, debts beyond the debtor's ability to pay; or
    - made such transfer or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

Fraudulent Transfer Standards Applied to LBOs

- **Reasonably Equivalent Value**
  - **Courts often find no reasonably equivalent value when the target company incurred significant obligations while the funds were passed on to the former shareholders.**
  - **Some courts also consider intangible benefits that the debtor may have received, such as operational synergies, new credit opportunities and "good will."**
- **Insolvency**
  - **Courts can consider facts unrelated to the LBO, such as the health of the industry more generally, in determining whether the LBO caused the company's poor financial health.**
- **Unreasonably Small Capital**
  - **Exists where a company bears an unreasonable risk of insolvency because it cannot support its operations.**

Common Affirmative Defenses

- **Transfers received in "good faith" and for "value"**
- **Settlement Payment Exemption**
  - **§ 546(c)**
  - **Broadly defined in § 741(8)**
  - **Judicial trend broadening application of this – 6th Circuit opinion in *QSI***

Recent Significant Cases

The TOUSA Decision

- **In 2005, home builder and developer TOUSA, Inc. and one of its subsidiaries issued unsecured guaranties in connection with the leveraged "Transeastern" joint venture. When the joint venture failed, Transeastern was unable to satisfy its debt obligations. The lenders looked to TOUSA as a guarantor. TOUSA agreed to pay more than $421 million to the Transeastern lenders.**
- **TOUSA borrowed $500 million from a syndicate of lenders to fund the settlement and pledged all of its and its subsidiaries' assets as collateral for the loan, despite the fact that few of the pledgors were defendants in the lender litigation.**
- **Less than six months after the loan to fund the settlement, TOUSA and its subsidiaries filed for chapter 11 relief.**
- **The Creditors' Committee commenced an adversary proceeding, alleging that the incurrence of the $500 million in debt and the settlement payments made with the funds were fraudulent transfers.**
- **TOUSA is not an LBO case, but the legal holdings have relevance in all fraudulent transfer cases.**

The Court Found The Transfers Were Fraudulent

- **The Court held that the transfers were constructively fraudulent, finding that reasonably equivalent value was not exchanged and that TOUSA and its subsidiaries had been insolvent both before and after the transfers. *Official Comm. of Unsecured Creditors of Tousa, Inc. v. Citicorp N. Am., Inc. (In re TOUSA, Inc.)*, 422 B.R. 783 (Bankr. S.D. Fla. 2009).**
- **The Court ordered the avoidance of liens held by the secured lenders, the disallowance of secured claims, and the disgorgement of any principal, interest, costs and expenses from the secured lenders, totaling more than $400 million.**
- **The decision is currently on appeal and no other court has yet followed the lead of the TOUSA Court.**

The Court Found TOUSA Was Insolvent

- **The Court found that each TOUSA entity was insolvent prior to the loan and after the loan.**
- **The Court found the Committee's expert testimony persuasive and found problems with the defendants' testimony.**
  - **The Court found significant flaws in defendants' presentation, including:**
    - **Defendant experts assumed market would not decline further as of the time of the transaction. The Judge found this not credible.**
    - **The expert misled the Court by stating that he had never served as an expert in a case where the Court did not ultimately adopt his valuation. The Court found this demonstrably false.**
    - **Defendants relied on "common enterprise" valuation, rather than debtor-by-debtor approach. However, the Court found that the debtors did not typically analyze the entity as a group outside this context. The Court found the relationship between TOUSA and its subsidiaries was "the typical relationship between corporate parents and subsidiaries" and the Court viewed the entities as distinct.**
    - **The Court relied on entity-by-entity valuation of the Committee. The Court rejected consolidated valuation of some defendants, holding that in the absence of substantive consolidation or veil piercing the Court could not treat individual entities as a group.**
    - **The Court also found that consolidated TOUSA was insolvent after the loan, but because each subsidiary was jointly and severally liable on billions of dollars in debt, by definition each subsidiary was rendered insolvent.**
    - **The Court appeared troubled by fact that defendants' experts offered multiple competing values.**
    - **The Court found intercompany obligations to be equity not debt.**

TOUSA Insolvency, (Cont'd.)

- **The Court found significant contemporaneous evidence that the company and the lenders believed the company was insolvent at the time of the loan.**
- **Defendants did not challenge significant portions of the Committee's presentation.**
- **The Court found TOUSA's CEO and professionals had incentives to consummate loan.**
- **The Court found TOUSA and subsidiaries had debt to total capitalization ratio of 71.3%.**
- **The Court found debt trading at severe discount at the time of the loan.**

The Court Found Lack Of Reasonably Equivalent Value

- **The Court found subsidiaries did not receive reasonably equivalent value.**
  - **The Court found subsidiaries received no direct benefits. The joint venture's remaining home inventory went to one subsidiary and was worth $28 million, but included $32 million of debt, and was worthless. No other direct value was exchanged.**
  - **The Court found subsidiaries received minimal indirect benefit.**
    - **Settlement of the litigation did not improve day-to-day operations.**
    - **The Court found subsidiaries received no benefit from forestalling TOUSA bankruptcy.**
      - **The Court relied on testimony that subsidiaries could have refinanced.**
    - **TOUSA executive's testimony showed the Company did not consider whether the transaction was good for each subsidiary.**
  - **The Court held that defendants put on no express evidence of value of indirect benefits.**
- **The Court found lenders did not act in good faith and were grossly negligent.**

The Court Did Not Consider Savings Clause

- **The savings clauses in the term loans would have amended the obligations and liens to make them "enforceable to the maximum extent" permitted by law.**
- **The Court found the savings clauses were not applicable for a number of reasons:**
  - **The conveying subsidiaries were insolvent before the loans were made and, therefore, the liens could not be enforced at all.**
  - **Savings clauses are unenforceable under section 541(c)(1)(B), which states that a property interest of debtor becomes property of estate notwithstanding any *ipso facto* clause providing for termination, forfeiture or modification of that interest.**
  - **The Court also found savings clause unenforceable because parties cannot contract around Bankruptcy Code.**

Boyer v. Crown Stock Distributing, 587 F3d 787 (7th Cir. 2009)

- **Sale of the assets, not the stock**
- **Despite highly leveraging the assets to finance the acquisition, buyer stayed in business over 3 years before filing bankruptcy**
- **Buyer assumed name of seller and concealed the transaction from creditors;**
- **Trustee sued to avoid the transaction and recover the amounts paid to the seller**
- **Trustee also sought to recover special dividend paid to seller's shareholders just before the sale**
- **7th Circuit held the entire transaction was a fraudulent conveyance and allowed recovery of the full consideration received plus the pre-closing dividend - even though this amount exceeded the amount of creditor claims. But any funds remaining after creditors were satisfied were required to be returned to the defendants.**
- **Ruling seems influenced by the concealment of the transaction from both old and new creditors**

Lyondell Chemical Company (Case No. 09-10023, Bankr. S.D.N.Y.)

- **$20 billion merger of Lyondell with Basell in July 2007**
- **Bankruptcy filed in January 2009**
- **Creditors Committee sued to void liens and claims of the lenders, and obtain damages from other parties**
- **Complex litigation, with many issues**
- **Debtor reached a settlement with the lenders involving payment of $300 million in cash and other consideration**

Lyondell Chemical Company (Cont'd.)

- **Debtor's settlement motion, approved over committee objection, outlines a number of issues to consider in analyzing potential exposure, including**
  - **Whether the various LBO transactions could be collapsed into one**
  - **Whether the transaction was protected under §546(e) as settlement payments**
  - **The Debtor's financial condition in 2007 and reasonableness of projections prepared at the time**
  - **Subsequent unforeseen events including oil price movements, an accident at a company plant, 2 Gulf hurricanes in 2008, the 2008 global financial crisis and the sudden drop in demand for its products**
  - **Over $7 billion of the financing was used to pay existing debt – which would constitute "value" if paid in good faith**
  - **Priority of liens avoided and preserved for the estate**
  - **Whether lenders' claims be equitably subordinated – if not, the $20 billion in lender claims would dwarf the $1.6 billion in recoverable unsecured claims**
  - **Only $1.6 billion in unsecured claims were filed against debtor entities that had substantial value to distribute**

Mervyn's Holdings, LLC (Case No. 08-11586, Bankr. D. Del, March 17, 2010)

- **Target sold Mervyn's, a chain of department stores, to Mervyn's Holdings (owned by 3 PE funds) in 2004**
- **Purchase price of $1.175 billion was financed by leveraged borrowing using the real estate as collateral**
- **After the closing, Mervyn's Holdings transferred the real estate to a sister company for little or no consideration, which then leased it back at more than twice the prior rent**
- **After Mervyn's filed chapter 11, the Creditor's Committee sued Target and the private equity owners, claiming that the loss of the value of the real estate and the over – leveraged financial condition caused the bankruptcy**
- **Suit alleged actual and constructive fraud, plus breaches of fiduciary duty**
- **Target filed a motion to dismiss**

Mervyn's (Cont'd.)

- **Bankruptcy Court denied the motion**
  - **The various transactions had to be collapsed because Target had sufficient knowledge of them and they wouldn't have taken place independent of the LBO and they were dependent on the others**
  - **The overall transaction was "devastating" to creditors, including stripping of the real estate, greatly increasing the rents, and creating an economic conflict of interest at the parent level**
  - **The LBO left the Debtor with as little as $22 million in working capital and saddled it with additional debt of $800 million**
  - **§546(e) settlement payments exemption did not apply – generally it doesn't apply to collapsed transactions and some of the transactions particularly the real estate transfers, were unrelated to the sale of securities**
  - **Breach of fiduciary duty – Target as member of insolvent LLC, had fiduciary duties to creditors under California law. If Mervyn's wasn't insolvent before the LBO, the stripping of the real estate caused it to become insolvent**

Tribune Company (Case No. 08-13141, Bankr. D. Del.)

- **In 2007, allegedly under pressure to cash out some of its major shareholders, the board of Tribune Company approved an LBO proposal by Chicago real estate developer Samuel Zell to take the company private.**
- **To finance the transaction, Zell caused Tribune to increase its debt load from $5.3 billion to $14 billion. Although the LBO financing was unsecured, it was guaranteed by Tribune's subsidiaries, who received little, if any, benefit from the loans.**
- **The Zell-controlled purchasing entity contributed $315 million and Zell was appointed CEO and Chairman of the Board.**
- **Tribune shareholders were paid more than $8 billion in the aggregate for their shares (nearly all of the new debt).**

Tribune, cont'd

- **Tribune filed for bankruptcy on December 8, 2008.**
- **On February 1, 2010, the Creditors Committee filed a motion seeking derivative standing to prosecute fraudulent transfer, against the banks that financed the LBO and others.**
- **On March 4, 2010, Wilmington Trust Company, as successor indenture trustee for certain subordinated debentures, commenced an adversary proceeding (Adv. No. 10-50732) asserting direct claims for equitable subordination, disallowance of claims and damages.**
- **On April 20, 2010, the Bankruptcy Court directed the appointment of an examiner to look into the asserted claims surrounding the LBO. All stages of related litigation have been put on hold pending the issuance of the examiner's report, which is to be issued on July 12, 2010.**

Extended Stay, Inc. (Case No. 09-13764, Bankr. S.D.N.Y.)

- **Extended Stay, Inc. and dozens of affiliated special purpose entities filed for bankruptcy protection on June 15, 2009. The Court appointed an examiner to investigate the 2007 leveraged buyout of the Extended Stay entities. The examiner recently filed its report, which contains an analysis of potential fraudulent transfer actions.**
- **In 2007, affiliates of The Blackstone Group sold Extended Stay to a group under the direction and control of Lightstone Holdings LLC for $8.0 billion.**
- **To finance the LBO, Extended Stay incurred an additional $1.8 billion in debt financing, while simultaneously encumbering all of its real and intellectual property as security for the loans. As in a typical LBO structure, the target company, Extended Stay, did not retain the loan proceeds. Rather, the proceeds were passed on to the Blackstone affiliates who had sold their interests in the entities.**
- **The Examiner recently reported that the transactions had left Extended Stay with unreasonably small capital to continue its operations and unable to pay its debts as they come due. The examiner concluded that the Extended Stay estates, either individually or on a consolidated basis, could adequately plead fraudulent transfer claims.**
- **No party has yet filed a complaint.**

Yellowstone Mountain Club, LLC (Case No. 08-61570, Bankr. D. Mont.)

- **In September 2005, Credit Suisse made a $375 million loan to Yellowstone Mountain Club, LLC and its affiliates.**
- **The loan agreement authorized the use of up to $209 million for purposes unrelated to the operation of Yellowstone. Yellowstone transferred approximately $209 million from Yellowstone to Blixseth Group, Inc. ("BGI"), which then transferred funds to Timothy Blixseth.**
- **The Yellowstone Club Liquidating Trust filed claims against Credit Suisse, Timothy Blixseth and others for fraudulent transfer and breach of fiduciary duties, among other things (Adv. No. 09-00014).**

Yellowstone, (cont'd.)

- **After the first phase of the trial, the Bankruptcy Court found that Credit Suisse improperly designed the loan principally to generate large fees while taking on minimal direct obligations. The Court also found that Credit Suisse marketed the loan by telling Blixseth that he could put a majority of the proceeds to his personal use. As a result, the Court equitably subordinated the claims of Credit Suisse to those of other creditors.**
- **The second phase of the trial, with respect to the fraudulent transfer claims against Timothy Blixseth and BGI, took place in February 2010.**
- **While the Bankruptcy Court's decision on the fraudulent transfer claims is pending, the parties intend to participate in a global mediation of the Yellowstone bankruptcy cases and related adversary proceedings in an attempt to reach a settlement. The mediation is set to take place in early May 2010.**

Structuring LBO Deals to Mitigate Risk

- ✓ **Understand that failed LBOs will likely be subject to litigation.**
- ✓ **Conduct a thorough, independent solvency analysis of borrower(s) at time of transaction.**
- ✓ **Analyze borrowers on both an individual and consolidated basis.**
- ✓ **Confirm exchange of reasonably equivalent value by contemporaneous valuation of transfer.**
- ✓ **When performing solvency analysis and valuation, expect that courts will "collapse" an LBO transaction and look at the net value received by the debtor, rather than consideration exchanged in the individual transactions.**
- ✓ **Ensure that any expert witnesses are credible and their methodologies are reasonable.**
- ✓ **Coordinate with co-defendants to present a unified analysis where possible.**