# CMBA Bankruptcy & Commercial Law Section Newsletter

FALL 2018 EDITION

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C M B A

CLEVELAND METROPOLITAN BAR ASSOCIATION

## Greetings from the Section Chair

**Philip D. Lamos**
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Dear fellow Section members,

Please allow myself to introduce myself (wait, that doesn't sound right). Phil Lamos here, Chief Legal Counsel for Lauren Helbling, the Chapter 13 Trustee and Chair of the CMBA's Bankruptcy and Commercial Law Section. As we plan for the upcoming year, I'm trying to live up to the high standards set by my predecessor as Section Chair, Suzana Koch of the U.S. Attorney's Office. Those of us who know Suzana know that she is a whirlwind of energy and determination, and I will consider my term a triumph if I am half a successful Chair as she was. I'm joined on the Executive Committee by Heather Heberlein, Kelly Burgan, Tiiara Patton, and Milos Gvozdenovic. The real brains behind the operation is, as always, the CMBA's Director of CLE, Sections & Committees, Samantha Pringle.

We've got several evens coming up that I think will be of interest to our membership. We're super excited about the **Pat E. Morgenstern-Clarren Bankruptcy Seminar**, a one-day even to be held at the Bar Association on **December 6th**. This seminar will be dedicated to timely and important issues in the consumer bankruptcy field. Ed Bailey, the Chair for this event, has promised that it will be better than *Avengers: Infinity War,* so watch your inboxes for more information!

Also coming up is the annual **William J. O'Neill Regional Bankruptcy Institute**, to be held this upcoming May. If you'd like to be part of the planning for this event, please let us know.

We've got many other exciting events coming up as well. We're co-sponsoring the **Bankruptcy and Turnaround Update** coming up on **October 18th** at the Bar Association. Our annual **holiday party** will be at the Bar Association on **December 6th**, after the Morgenstern-Clarren Seminar. We're especially pleased to announce that coming this January, we'll be putting on an event in conjunction with the Cleveland Housing Court about the interaction between Housing Law and Bankruptcy. We've got still more events coming too, so be on the lookout!

Everything our Section does, from our various events and seminars (most of which are CLE-friendly, natch) to this newsletter are for you, our membership. We want to be what you need us to be. If you want to help with an upcoming seminar, or if you want to contribute to the newsletter, or if you've got an idea for anything, just let us know. We're here for you.

Excelsior!

Phil

# Lender Risk Calculus in Financing Leveraged Transactions Changes as Supreme Court Shrinks Securities Transaction Participants' "Safe Harbor" in Bankruptcy Fraudulent Transfer Actions

## By Jeffrey W. Bieszczak and Jeffrey A. Marks

Leveraged transactions, such as leveraged buyouts and leveraged recapitalizations, carry the risk of being unwound in a later bankruptcy of the party that transferred assets (including granting liens) or incurred obligations in the transaction. The risk that such transactions may be upset in bankruptcy extends, of course, to selling shareholders in an LBO and to shareholders who receive purchase price funds or dividends in a leveraged recap. These parties may be forced to disgorge some or all of the funds received if the trustee or other suing party prevails in an action to "avoid" (or set aside) the transaction as a fraudulent conveyance (which may or may not involve actual fraud). The risk to lenders who financed the transaction lies in the potential that their liens and claims against the debtor may also be avoided, and that fees and loan repayments received may be clawed back. Although there may have been no recent high-profile court decisions avoiding a lender's liens or claims, lender fraudulent transfer risks certainly have not vanished. Lenders have settled significant fraudulent transfer claims by unsecured creditors in such cases as *LyondellBasell*[1] and *Tribune Company*[2] and other lesser known cases.

The risk of unwind in public and private leveraged transactions was thought to have been reduced to some extent by structuring the transaction so that transfers of funds and securities pass through certain participants in the financial and securities industries in order to take advantage of the "safe harbor" found in Section 546(e) of the Bankruptcy Code. As a result of the Supreme Court's recent decision in *Merit Management Group, LP v. FTI Consulting, Inc.*,[3] this safe harbor protection has diminished, although the decision leaves significant questions unanswered.

**Background**

Generally speaking, bankruptcy trustees (and Chapter 11 debtors and, in certain circumstances, creditors' committees or other estate representatives) have the power to set aside certain transfers made, or obligations incurred, by a debtor prior to a bankruptcy filing where the transfer or obligation was made to defraud creditors or did not return reasonably equivalent value to the debtor. Among other provisions, Section 546 of the Bankruptcy Code sets certain limits on the trustee's powers, including a safe harbor under subsection (e) that protects margin payments, settlement payments and other transfers made in connection with securities contracts where the transfer is made "by or to" (or for the benefit of) certain protected entities and does not involve actual fraud by the debtor. The protected entities include financial institutions, commodity and stock brokers and securities-clearing agencies. As noted above, the Section 546 safe harbor is often implicated in failed LBOs where the buyout proceeds pass from the debtor through one or more protected entities prior to receipt by the seller. Prior to *Merit Management,* lower federal appeals courts had reached differing conclusions as to whether a protected entity that is a "mere conduit" or other intermediary with respect to the transaction is sufficient to bring the ultimate transferee within the protection of the safe harbor.

*Merit Management* involved a failed LBO transaction between Valley View Downs, LP (Valley View), and Bedford Downs Management Corp. (Bedford), two competing would-be "racino" operators vying for Pennsylvania's final racino operating license. In exchange for Bedford withdrawing from contention for the license, Valley View agreed to purchase all of Bedford's outstanding stock for $55 million. Credit Suisse financed Valley View's

acquisition of Bedford, and at closing wired the $55 million purchase price into an escrow account at Citizens Bank. The selling shareholders deposited their stock certificates in escrow with Citizens Bank as well. Citizens Bank then transferred the funds to Bedford's shareholders, including Merit Management. Valley View subsequently failed to obtain a state gaming license needed to operate its racino, resulting in a default under its credit facility and a chapter 11 bankruptcy filing soon thereafter.

The bankruptcy court appointed FTI Consulting (FTI) as Valley View's bankruptcy litigation trustee to prosecute claw-back actions on behalf of Valley View's bankruptcy estate. FTI sued Merit Management and other former Bedford shareholders for recovery of the proceeds of the stock sale, including the $16.5 million received by Merit Management. FTI alleged that Valley View had grossly overpaid for Bedford's stock and was rendered insolvent as a result of the stock purchase, rendering the transaction constructively fraudulent as to Valley View's creditors. Merit Management claimed that because the stock purchase proceeds passed through two protected financial institutions, Credit Suisse and Citizens Bank, before being delivered to Merit Management, the payment fell within Section 546(e)'s safe harbor and could not be recovered. Though the bankruptcy court ruled in favor of Merit Management, the lower appeals court reversed, concluding that the safe harbor does not protect transactions where protected entities are "mere conduits" through which a transfer passes and not the original transferor or ultimate transferee.[4]

**The Ruling**

The Supreme Court unanimously affirmed the appellate court's decision, ruling that the "overarching" transfer sought to be set aside and not the identity of any intervening parties involved in consummating the transfer, is controlling as to whether the safe harbor applies. Since the "overarching" transfer targeted by FTI was the $16.5 million payment from Valley View to Merit Management, neither of whom was a protected entity under Section 546(e), the safe harbor did not apply. The Court was unmoved by Merit Management's argument that narrowly interpreting the safe harbor would lead to widespread turbulence and unpredictability in the securities markets.

**The Takeaways and Unanswered Questions**

In the short term, *Merit Management* will likely embolden bankruptcy trustees to aggressively pursue fraudulent transfer actions in bankruptcy cases involving failed LBOs, leveraged recaps and other unsuccessful securities transactions. The Court has opened the door to challenges to the trustee's characterization of the relevant transfer at issue in each case. Although the Court ruled that the only relevant transfer for purposes of the safe harbor is the transfer that the trustee seeks to avoid, that does not mean that the trustee's identification of the transfer is necessarily correct. The Court noted that Merit Management never challenged FTI's characterization of the transfer, instead arguing that the mere fact that the stock purchase proceeds passed through a protected financial institution was sufficient to bring the entire, broader transaction within the protection of the safe harbor. Securities transaction participants faced with a lawsuit to which the safe harbor might apply should closely scrutinize the bankruptcy trustee's characterization of the transaction at issue and determine whether dissembling the transaction into its constituent parts might better support invoking Section 546(e)'s safe harbor protections.

Another open question is whether the debtor or the ultimate recipient of the transfer may itself qualify as a "financial institution" (one of the protected entities under the Section 546(e) safe harbor) if it is a "customer" as defined in the Bankruptcy Code. Although this issue was discussed at the oral argument in *Merit Management*, the Supreme Court expressly did not answer this question. The Bankruptcy Code provides that where 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 a receiver, liquidating agent, or conservator for such an entity) is acting as an "agent" or "custodian" for a "customer," the customer is itself a "financial institution." So whether, for example, a bank serving as an escrow agent, or a bank lender who wires loan proceeds, in the transaction is acting as agent or custodian for a customer within the meaning of this provision, remains a potential basis for application of the safe harbor.

By interpreting the securities transaction safe harbor narrowly, it is clear that *Merit Management* heightens the risk of unwind in certain leveraged transactions that are otherwise vulnerable to attack on fraudulent transfer grounds. Accordingly, lenders should take account of this as part of an effective underwriting process for relevant leveraged lending transactions, and as part of any settlement analysis should a bankruptcy filing and avoidance litigation ensue.

[1] *In re: Lyondell Chemical Company, et al., Debtors*, Case No. 09-10023, Adv. Pro. No. 09-01375, U.S. Bankruptcy Court for the Southern District of New York (settlement approved by court in 2010).
[2] *In re: Tribune Co. et al.,* Case No. 08-13141, U.S. Bankruptcy Court for the District of Delaware (settlement approved by court in 2012).
[3] 138 S.Ct. 883 (2018)
[4] *FTI Consulting, Inc. v. Merit Management Group, LP*, 830 F.3d 690 (7th Cir. 2016).
[5] 138 S.Ct. at 890 n.2 (2018)
[6] 11 U.S.C. § 101(22).

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July 2018 - June 2019

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# Keeping Special Revenues "Special"

## By Karol Denniston and Peter Morrison

Special revenues may not be as special as many bondholders have historically expected. Two recent rulings [1] from District Court Judge Laura Taylor Swain in the Puerto Rico PROMESA proceeding have held that bond issuers are not required to make post-petition special revenue bond payments during a pending Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA")[2] Title III bankruptcy proceeding. Judge Swain also held that unless the Oversight Board authorizes special revenue payments, the court lacks authority to compel the payment. The rulings are at odds with existing precedent, legislative history, and market expectations and have alarmed the municipal finance industry.

We look at the immediate impact of Judge Swain's interpretation of the Bankruptcy Code—pending appeal—and consider how to mitigate bondholder risk for new special revenue secured bond issuances.

**What does the Bankruptcy Code say about special revenues?**

Special revenues are revenues derived from a project or system, for example toll revenue generated by a highway or bridge project. Under section 928 of the Bankruptcy Code, special revenues acquired after the commencement of the case remain subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

Section 922 of the Bankruptcy Code expressly provides that the filing of a petition does not operate as a stay of application of pledged revenues to payment of indebtedness secured by such revenue. The marketplace has commonly understood that section 922 of the Bankruptcy Code protects special revenues and directs their payments to issuers notwithstanding a pending bankruptcy.

**What did Judge Swain say about the automatic stay and special revenues?**

Despite market expectations, Judge Swain held in the Assured Adversary Proceeding that the holders of special revenue bonds cannot compel the debtor to apply special revenues to debt service post-petition. Specifically, the Court held that the exception to the automatic stay found in section 922(d) did not authorize actions to compel the debtor to apply net special revenues to debt service—it merely allows debtors to voluntarily make such payments if they so choose.

Judge Swain cited legal commentary, noting that nothing in the plain language of section 922(d) demonstrates congressional intent to give the holders of special revenue secured bonds the power to compel continued application of such revenues to payments during the course of a Chapter 9 proceeding.

**Is this ruling consistent with the Bankruptcy Code and prior precedent?**

Legislative history suggests that section 922(d) was intended to avoid the impairment of special revenue bonds in bankruptcy by excluding such payments from the automatic stay. Indeed, the market has long viewed the continuation of payments on special revenue debt as a certainty.

Consistent with that expectation is Judge Thomas Bennett's decision in the Jefferson County Chapter 9 proceeding. In Jefferson County, Judge Bennett analyzed a pledge of special revenues pursuant to the definition contained in section 902(2)(A) to find that specifically pledged sewer revenues were not subject to the automatic stay.[3] Judge Bennett held that the automatic stay does not bar application of pledged special revenues to indebtedness, regardless of whether the special revenues are generated pre- or post-petition or whether they have been paid over to the trustee. The Jefferson County opinion does not address whether such payments were voluntary or compulsory, but the ruling is consistent with perception that Congress intended to protect special revenues in an effort to ensure a stable municipal finance market.

**What is the Basis for Judge Swain's Opinions?**

Judge Swain dismissed the bondholder's claims in the Assured Adversary Proceeding, holding that section 922(d) only grants a municipality "permission" to continue paying special revenue obligations in its discretion during a bankruptcy and does not compel a debtor to make such payments. The Court narrowly read the plain language of section 922(d), finding no express payment obligation, and concluded that section 922(d) does not sanction non-consensual interference with governmental properties or revenues under section 305 of PROMESA. Section 305 of PROMESA is similar to section 904 of the Bankruptcy Code—they both protect debtor property from court interference. Section 904 generally prevents a court from issuing any stay, order, or decree that might interfere with any of the property or revenues of the debtor. Under section 304 of PROMESA, the consent of the Oversight Board is required or the enforcement must be in connection with a plan of adjustment if property rights or revenues are to be implicated.

While the ACP Adversary Proceeding merely touches on the authority of the court under section 305 of PROMESA, the Assured Adversary Proceeding takes a deeper dive. In the Assured Adversary Proceeding, Judge Swain dismissed a complaint by bondholders regarding the payment of special property tax and clawback revenues, ruling that section 305 of PROMESA restricted the court's ability (notwithstanding its subject matter jurisdiction) to enforce the payment of special revenues post-petition because the Oversight Board did not consent to such payments. Judge Swain read section 305 of PROMESA broadly. Taking these two opinions together, Judge Swain has held that where the debtor is in possession of the special revenue proceeds and they have some property interest in those funds (be it a small reversionary interest or something else) or the funds are the debtor's revenues, the Bankruptcy Code does not compel that the payments be made and section 305 of PROMESA prevents the court from ordering the Debtor to pay.

**How Safe Are Special Revenues?**

Not as safe as they were prior to Judge Swain's rulings, but safe enough if a bondholder is able to establish as a matter of law that they hold an enforceable security interest and lien on special revenues. Bondholders with liens are still able to prove their lien and seek payment and/or adequate protection once a Chapter 9 proceeding is filed.

The market's reliance on the assumption that the Bankruptcy Code protects special revenues and mandates their application to debt service in a Chapter 9 proceeding must adjust to reflect the new reality—that the payment of special revenue bonds post-petition is not mandatory, but permissive. Both rulings are on appeal to the First Circuit Court of Appeals[4] and, until those appeals are determined, parties structuring special revenue bond issuances should consider the difference between permissive and mandatory turnover of special revenues post-petition in pricing and in accessing risk in the event of an issuer Chapter 9 filing.

If a special revenue issuance is protected by a state statutory lien, there may be broader protection in the event of a Chapter 9 filing. This is particularly true if the state statute requires the special revenues to be received by a third party, never be in the possession, custody or control of the issuer, and state or other applicable law requires that the funds received be applied to debt service.[5]

Bond documents should clearly identify the statutory lien and be consistent with state statutory requirements regarding the flow of funds. There is greater protection when a statute prohibits the issuer from ever receiving the special revenues because under this scenario, to allow a debtor to receive and perhaps reallocate special revenues would be a violation of state law. It is important when issuing special revenue secured debt pursuant to a state statute that the offering statement, indenture, issuer's resolution, and payment agent agreement are consistent and comply with the statute.

## What Does the Future Hold?

It depends on what the First Circuit determines on appeal. If the First Circuit accepts Judge Taylor's statutory interpretation, then the certainty previously enjoyed with regard to turnover of special revenues post-petition must be reconsidered in terms of deal structure and pricing and risk to enforceability during a bankruptcy proceeding. Market access for some issuers will be limited unless state law provides for a statutory lien and payment through a third party intermediary and not the debtor. Should the First Circuit uphold Judge Swain's ruling, we expect that there will be pressure on Congress from all parties within the municipal finance industry, including issuers, to revise section 922(d) to require or mandate turnover of special revenues after a Chapter 9 filing.

[1] *Assured Guaranty Corp. et al. v. Commonwealth of Puerto Rico et al.* Adv. Proc. No. 17-155-LT and 17-155-LTS (Bankr. D.P.R., January 30, 2018) ("Assured Adversary Proceeding"); *ACP Master, LTD., et al. v. The Financial Oversight and Management Board for Puerto Rico as representative of Commonwealth of Puerto Rico, et. al.,* Adv. Proc. No. 17-189-LTS (Bankr. D.P.R., Jan. 30, 2018) ("ACP Adversary Proceeding"). The Assured Adversary Proceeding and the ACP Adversary Proceeding were filed in *In re The Financial Oversight and Management Board For Puerto Rico, as representative of Commonwealth of Puerto Rico*, No. 17BK 3283-LTS (Bankr. D.P.R.). The Puerto Rico Highways and Transportation Authority ("PRHTA") is one of several Title III debtors.

[2] PROMESA was enacted by the U.S. Congress and signed into law in 2016. PROMESA is codified at 48 U.S.C. §§2101, *et seq.*

[3] *In re Jefferson Cnty., Ala.,* 47 B.R. 228, 262-74 (Bankr. N.D. Ala. 2012).

[4] *See* appellate case numbers 18-1165/18-1166 (Assured) and 18-1108 (ACP Master Fund).

[5] Note that in the *Assured* case, the Puerto Rico Fiscal and Advisory Authority, on behalf of PRHTA, delivered instructions to the fiscal agent directing the agent not to make scheduled payments to bondholders and that any such payment, if made, would violate the automatic stay under PROMESA. Accordingly, the fiscal agent did not make the payments.

Bankruptcy & Turnaround Update

Thursday, October 18
12-4:15 p.m.
3.75 CLE Hours

EIGHTH ANNUAL