Lender Risk Calculus Changes in Financing Leveraged Transactions

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Leveraged transactions, such as leveraged buyouts (LBO) 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* and *Tribune Company* 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.*, 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.

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.