

LBOs and Fraudulent Conveyances: The Third Circuit Does an About Face

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In a simple form leveraged buyout, a company (Target) is sold pursuant to a financial arrangement whereby the Target borrows all, or a significant portion, of the purchase price and mortgages its assets to secure the loans for the purchase price. In more complicated LBOs, a shell corporation is formed, which borrows a large portion of the purchase price (the Target gives liens on its assets to secure repayment of bank loans and/or bond debt) and, following a tender offer for the Target's shares, merges into the Target.

Regardless of the form of the LBO, borrowed money is paid to the Target's former shareholders in exchange for their shares—arguably, worthless pieces of paper. The new owner receives control of the Target, sometimes for relatively little or no new capital. If the Target collapses under its new debt obligations, unsecured creditors may look hard at whether the LBO constituted a constructive fraudulent conveyance and may be avoided through a civil action.

Their theory: through the LBO, former shareholders (defendants) received transfers (cash payments) from the Target for less than reasonably equivalent value (stock) and the transaction rendered the Target either insolvent or with unreasonably small capital (in light of the Target's significant debt obligations). See 11 U.S.C. § 548(a)(1)(B) and Norton Bankr. L. & Prac. 2d @ 58A:1.

Initial Third Circuit Ruling

Fourteen years ago, the Third Circuit Court of Appeals, in *U.S. v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, *McClellan Realty Co. v. U.S.*, 483 U.S. 1005, 107 S.Ct. 3229, 97 L. Ed. 2d 735 (1987), ruled that, under certain circumstances a trustee in bankruptcy may prosecute fraudulent conveyance claims against parties that orchestrated a pre-petition leveraged buyout of the debtor.

This was a watershed ruling for several reasons. First, the case involved the first significant application of the Uniform Fraudulent Conveyance Act to failed LBOs. *Id.* at 1290. Second, the court rejected weighty academic commentary arguing that fraudulent conveyance law should not be applied to leveraged buyout transactions. *See, e.g.*, Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and its Proper Domain*, 38 Vand. L. Rev. 829, 852 (1985) ("A firm that incurs obligations in the course of a buyout does not seem at all like the Elizabethan deadbeat who sells his sheep to his brother for a pittance.") Third, the opinion established widely accepted precedent: "courts now uniformly hold that fraudulent conveyance laws apply to LBOs," *MFS/Sun Life Trust v. Van Dusen Airport Services Co.*, 910 F. Supp. 913, 933 (S.D.N.Y. 1995), even though some courts were initially swayed by the legal commentary arguing for the opposite ruling, *see, e.g.*, *Kupetz v. Wolf*, 845 F.2d 842 (9th Cir. 1988); *Credit Mgrs. Ass'n. v. Federal Co.*, 629 F. Supp. 175, 179 (C.D. Cal. 1985). Consequently, it can be said that the expansive body of case law applying fraudulent conveyance principles to leveraged buyouts emanates from the Third Circuit.

This past summer, however, the Third Circuit made an abrupt and surprising about-face. In *Lowenschuss v. Resorts International, Inc. (In re Resorts International, Inc.)*, 181 F.3d 505 (3d

Cir.), *cert. denied*, U.S., 120 S. Ct. 531, L. Ed. 2d (1999), the court held that a trustee in bankruptcy cannot pursue fraudulent conveyance claims against a former shareholder who tendered his/her shares for cash as part of a leveraged buyout of the debtor, if such payments were made by the debtor to a stockbroker or financial institution (such as a bank), as go-between, to be delivered to the former shareholder. In reaching this holding, the court construed the "plain meaning" of Section 546(e) as divesting the trustee of avoiding powers with respect to the former shareholder because the shareholder received "a settlement...made by or to a...stockbroker [or] financial institution... before the commencement of the case." 11 U.S.C. § 546(e)[1] Since it is typical for stockholders to receive corporate distributions through a broker or request that payments be made directly to a bank account, the court's holding would appear to protect most former shareholders who would otherwise be targets of a fraudulent conveyance attack by the bankruptcy estate.

Lowenschuss v. Resorts International, Inc.

The Facts And Procedural History

Lowenschuss stems from the 1988 leveraged buyout of Resorts International, Inc. by Griffco Acquisition Corporation. Under the terms of the LBO, Griffco agreed to purchase Resorts stock for \$36 per share. Resorts sent a proxy statement to all of its shareholders that explained the terms of the merger and that the shareholders had the right to receive \$36 per share or to seek appraisal rights in the Delaware Chancery Court under Section 262 of the Delaware Corporation Law.

The merger was ultimately approved by the Delaware Chancery Court and consummated. Resorts then sent a "Notice of Merger of Griffco Acquisition Corp. With and Into Resorts International Inc." and a "Transmittal Letter" to shareholders, explaining that they could either tender their shares and receive \$36 per share or obtain an appraisal. Fred Lowenschuss, a shareholder, sent Resorts a letter demanding an appraisal.

At the same time, Lowenschuss filed an appraisal action in the United States District Court for the Eastern District of Pennsylvania. One week later, Resorts petitioned for an appraisal in Delaware Chancery Court, identifying Lowenschuss as a shareholder seeking appraisal. The district court dismissed Lowenschuss' claim without prejudice, deferring to the proceedings in Delaware. The Delaware Chancery Court issued a "Notice of Entitlement to Appraisal," explaining that shareholders seeking appraisal must "deliver [their] stock...certificates to the Register in Chancery within sixty (60) days of this notice [or risk] dismissal of the appraisal proceedings as to [their] shares." Lowenschuss never delivered his shares. Instead, he filed an amended complaint in the Eastern District of Pennsylvania against Resorts and others, moving for reconsideration of his request for an appraisal of the shares under his control. The district court dismissed the action without prejudice, again because of the Delaware Chancery Court proceedings.

Lowenschuss next filed (again in the Eastern District of Pennsylvania) a "Petition Requiring Resorts...to Pay \$36.00 Merger Price to Plaintiffs Immediately for 105,900 Shares of Resorts Class A Stock Owned by Plaintiffs and Which Are Hereby Being Tendered and to Complete the Record." In the petition, he stated: "Plaintiffs are hereby tendering all of their Resorts International, Inc. Class A shares totaling One hundred and Five thousand Nine hundred (105,900) shares for immediate payment of the merger price of Thirty-six Dollars (\$36.00) per share plus the interest which plaintiffs may be entitled to."

Four days later, Lowenschuss tendered his shares to Merrill Lynch, his broker, which in turn tendered them to the Chase Manhattan Bank, Resort's transfer agent for the merger. Chase forwarded a list of the tendering shareholders to Resorts and asked Resorts to wire funds to the payment account. Approximately two weeks after the tender, Resort's treasurer authorized the transfer of funds to Chase. Chase then delivered a check to Merrill Lynch for \$3,805,200.00, which it paid over to Lowenschuss.

When Resorts realized that it had paid Lowenschuss the merger price, it filed a lawsuit seeking to recover the payment. Resorts subsequently filed for Chapter 11 relief with the United States Bankruptcy Court for the District of New Jersey, and the lawsuit was removed from the Eastern District of Pennsylvania to the bankruptcy court. Resorts sought restitution of the transferred funds on a number of grounds, including that the payment to Lowenschuss was a fraudulent conveyance avoidable under Section 548.

The bankruptcy court awarded Resorts full restitution. On appeal, the district court reversed. Resorts appealed the district court's ruling to the Third Circuit arguing, among other things, that the transaction was avoidable as a fraudulent conveyance.

The Third Circuit's Holding And Reasoning

The Third Circuit affirmed the district court's decision, holding that Section 546(e) divests Resorts of its powers to avoid the transfer to Lowenschuss. As noted above, Section 546(e) prevents the trustee from avoiding a fraudulent conveyance that constitutes a securities "settlement payment" made by or to, among others, a stockbroker or financial institution.

The court stated that, in *Bevill, Bresler & Shulman Asset Management Corp. v. Spencer Savings & Loan Association*, 878 F.2d 742 (3d Cir. 1989), it adopted an "extremely broad" interpretation of "settlement payment" for purposes of Section 546(f), reflecting what it perceived to be Congress' intent to protect the nation's securities industry and its participants from financial attack by a bankruptcy trustee in the event a member of the securities industry filed for bankruptcy protection. The court thought application of the "extremely broad" interpretation of "settlement payment" in *Bevill* would encompass Resorts' payment to Lowenschuss.

The court noted that the only other federal court of appeals to directly address the issue presented in this case, the Tenth Circuit in *Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.)*, 952 F.2d 1230, 1239-40 (10th Cir. 1991), *cert. denied*, 505 U.S. 1213, 112 S. Ct. 3015, 120 L. Ed. 2d 887 (1992), held that payments to former shareholders as part of an LBO were "settlement payments" for the purposes of Section 546(e). *See also In re Comark*, 971 F.2d 322, 325 (9th Cir. 1992) (citing *Kaiser Steel* approvingly for the proposition that "a settlement is 'the completion of a securities transaction.'"). In the Third Circuit's view, the general thrust of *Kaiser Steel*, *Bevill* and *Comark* was that the term "settlement payment" is a broad one that includes almost all securities transactions.

The court acknowledged that a number of commentators have criticized *Kaiser Steel* arguing that LBOs generally do not implicate Congress' concerns about protecting the securities industry's clearance and settlement system. It also conceded that a number of lower courts have held that the term "settlement payment" does not include payments made for shares by a corporation as part of an LBO because the system of intermediaries and guarantees involved in traditional securities transactions is not in play in an LBO transaction. The court, however, concluded that a payment for shares during an LBO was "obviously" a common securities

transaction, and it therefore held that it was also a settlement payment for the purposes of Section 546(e).

A Split of Authority Among the Circuits Remains Unresolved

Resorts urged the court to follow the Eleventh Circuit's opinion in *Munford Inc. v. Valuation Research Corp.*, 98 F.3d 604 (11th Cir. 1996), *cert. denied*, 522 U.S. 1068, 118 S. Ct. 738, 139 L. Ed. 2d 675 (1998). The court refused.

In *Munford*, the Eleventh Circuit took a less formalistic view of Section 546(e), viewing the financial institutions involved in a leveraged buyout as nothing more than intermediaries or conduits through which cash was transferred to former shareholders. According to the *Munford* court, "[f]unds were deposited with the bank and when the bank received the shares from the selling shareholders, it sent funds to them in exchange. The bank never acquired a beneficial interest in either the funds or the shares." *Id.* at 610. The court reasoned that a trustee in bankruptcy may only avoid transfers to a "transferee," and that the bank was not a transferee because it never acquired a beneficial interest in the funds. It concluded that the former shareholders were the only "transferees" of the funds and that Section 546(e) offered no protection from the trustee's avoiding powers to shareholders. The court therefore held Section 546(e) inapplicable.

The Third Circuit found the *Munford* dissent more persuasive. The dissent did not think it appropriate to read a "beneficial interest" requirement into Section 546(e) where such requirement was not otherwise explicit. The Third Circuit concurred, finding no reason to disregard the section's "plain language."

In the fall, Resorts filed with the United States Supreme Court its petition for a writ of certiorari to review the *Lowenschuss* opinion. This past December, the Supreme Court denied Resorts's petition, despite the clear conflict between the rule adopted in the Third and Ninth Circuits, on the one hand, and the rule adopted in the Eleventh Circuit, on the other hand. This is the third time the Supreme Court has declined to address the issue, having previously denied petitions for writs of certiorari in *Kaiser Steel* and in *Munford*.

Some Ruminations on *Lowenschuss v. Resorts Int'l, Inc.*

Immediate Considerations

Are leveraged buyouts "safer" transactions following the *Lowenschuss* decision? One might be inclined to quickly come to that conclusion. The opinion supports the conclusion that the Bankruptcy Code immunizes former shareholders from fraudulent conveyance attack by the bankruptcy estate. If former shareholders are now protected, so seem to be other LBO participants, such as the lending institutions and bond purchasers that financed the transaction and the new owners of the company. These other participants would likely have been pulled into an estate action against the former shareholders to avoid the LBO. For attorneys advising a troubled company with LBO debt obligations or any of the company's creditors, *Lowenschuss* can be read as stripping the company's bankruptcy estate of a potentially valuable asset: the lawsuit against the former shareholders. Moreover, from the perspective of firms in the business of orchestrating leveraged buyouts, the opinion certainly is a positive development that may help in consummating difficult transactions.

There are, however, limitations to the *Lowenschuss* rule. Perhaps axiomatic, the rule does not apply if the company does not file for bankruptcy protection. If the elements of the cause of action are available, the company may pursue fraudulent conveyance claims against its former shareholders outside of bankruptcy under state fraudulent conveyance statutes (that is, presuming that the post LBO board operates with sufficient independence from the company's new owners to authorize such action outside of bankruptcy oversight). The former shareholders will not be able to rely on the "settlement payment" defense of Section 546(e) in such a case: no comparable provision is incorporated into the Uniform Fraudulent Transfer Act or the Uniform Fraudulent Conveyance Act. Depending on the company's financial situation, the company and creditors may opt, as part of an out-of-court workout, to protect and prosecute a valuable cause of action belonging to the company against the former shareholders rather than immediately seeking bankruptcy protection for the company.

Second, the *Lowenschuss* rule applies in only the Third and the Tenth Circuits. In light of *Munford*, former shareholders may not rely on the Section 546(e) defense in the Eleventh Circuit. Furthermore, as alluded to above, lower courts in Texas, Illinois and Massachusetts have sided with the Eleventh Circuit and refused to follow the *Lowenschuss* rule. See *Jewel Recovery, L.P. v. Gordon (In re Zale Corp.)*, 196 B.R. 348 (N.D. Tex. 1996); *Wieboldt Stores, Inc. v. Schottenstein*, 131 B.R. 655 (N.D. Ill. 1991); *Brandt v. Hicks, Muse & Co., Inc. (In re Healthco Int'l, Inc.)*, 195 B.R. 971 (Bankr. D. Mass. 1996). In the many remaining jurisdictions, the issue has not been adjudicated and it is impossible to predict how the courts would rule. Thus, *Lowenschuss* creates important "forum shopping" issues that must be considered and can be used strategically in future cases.

Moreover, no simple answer can be discerned because the company files for bankruptcy protection in the Third Circuit. Although Delaware has long been a jurisdiction of choice for filing complex Chapter 11 cases, a Delaware filing by a "busted LBO" does not necessarily mean that former shareholders can rest easy. Bankruptcy Code Section 544(b) provides a trustee in bankruptcy or a debtor in possession with avoidance powers available "under applicable law," implicating choice of law principles. Under federal common law choice of law rules, the law of the jurisdiction with the "most significant relationship" with the transaction and the parties will apply—not the law of the jurisdiction where the Chapter 11 case is pending. See, e.g., *SEC v. Infinity Group Co.*, 27 F. Supp. 2d 559, 564 (E.D. Pa. 1998); *In re Best Prods. Co.*, 168 B.R. 35, 50 (Bankr. S.D.N.Y. 1994), *aff'd*, 68 F.3d 26 (2d Cir. 1995). Factors to be considered in determining the jurisdiction with "the most significant relationship" include: the place where the transfer occurred; the place where the LBO transaction occurred; the domicile, residence, nationality, place of incorporation and place of business of the parties; and, the place where the relationship, if any, between the parties is centered. See *id.*

Thus, to illustrate by hypothetical, it seems safe to presume that a Delaware Chapter 11 filing will not protect former shareholders that reside in Florida who received cash in exchange for their shares as part of an LBO orchestrated in Florida of a company with its principle assets and businesses operating in Florida. In such a case, the court adjudicating the fraudulent conveyance action against the former shareholders likely will rely on Eleventh Circuit law—the *Munford* rule—rather than the law that is binding in the Third Circuit.

Long-term Considerations

Perhaps a more interesting issue from the perspective of academics and legal pundits concerns the long-term implications of *Lowenschuss*. As the *Lowenschuss* court acknowledged, the Tenth Circuit's 1991 *Kaiser Steel* opinion invoked a storm of criticism. See, e.g., Neil M. Garfinkel, *No*

Way Out: Section 546(e) is No Escape for the Public Shareholder of a Failed LBO, Colum. Bus. L. Rev. 51 1991; Gerald K. Smith & Frank

R. Kennedy, *Fraudulent Transfers and Obligations: Issues of Current Interest*, 43 S.C. L. Rev. 709 (1992); William C. Rand, *In re Kaiser Steel Corporation: Does Section 546(e) of the Bankruptcy Code Apply to a Fraudulent Conveyance Made in the Form of an LBO Payment?*, 19 Fordham Urb. L.J. 87 (1991); Jane Elizabeth Kiker, *Judicial Repeal of Fraudulent Conveyance Laws; Kaiser Steel Corp. v. Charles Schwab & Co.*, 913 F.2d 846 (10th Cir. 1990), 14 Hamline L. Rev. 453 (1991). It seems safe to conclude that *Lowenschuss* will not sit any easier with these critics.

The commentators argued that the "settlement payment" defense, as adopted by the *Lowenschuss* and *Kaiser Steel* courts, embraces an overly formalistic interpretation of Section 546(e) that disregards Congress' intent. They noted that Section 546(e) does not, on its face, suggest Congress intended to immunize cashed out shareholders from a fraudulent conveyance attack. Nor does the legislative history indicate that Congress had such intention. Rather, the section's legislative history suggests that the section was designed for a different purpose: to prevent disruption in the securities industries caused by the insolvency of one commodity or security firm leading to the insolvency of another. See H.R. Rep. No. 420 at 261 (1982) ("The commodities and securities markets operate through a complex system of accounts and guarantees. Because of the structure of the clearing systems in these industries and the potential volatile nature of the markets, certain protections are necessary to prevent the insolvency of one commodity or security firm from leading to the insolvency of other firms and possibly threatening the collapse of the affected market.") Several courts addressing this issue after *Kaiser Steel*, but before *Lowenschuss*, found the commentary persuasive and refused to follow the *Kaiser Steel* holding. See, e.g., *Munford*, 98 F.3d at 610; *Jewel Recovery*, 196 B.R. 348; *Wieboldt Stores*, 131 B.R. 655; *Healthco Int'l.*, 195 B.R. 971.

Lowenschuss thus raises the following important question: has the Third Circuit revived and given credibility to a theory of law that commentators and jurists have long reviled? The answer remains to be seen.

[1] *Bankruptcy Code Section 546(e) provides as follows:*

Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, or securities clearing agency, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

11 U.S.C. § 546(e). Section 548(a)(1)(A) authorizes a trustee in bankruptcy or debtor in possession to avoid intentional, as opposed to constructive, fraudulent conveyances; i.e., those conveyances made "with actual intent to hinder, delay, or defraud" creditors.