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Not So Safe After All?

United States Bankruptcy Court for the District of Delaware Holds That Litigation Trustee May Pursue State Law Fraudulent Conveyance Claims, Notwithstanding Bankruptcy Code Safe Harbors

On June 20, 2016, the United States Bankruptcy Court for the District of Delaware (the "Bankruptcy Court") denied in part a motion to dismiss and allowed state law constructive fraudulent transfer claims to proceed, despite the fact that such claims likely would have been precluded by the Bankruptcy Code's safe harbors if brought pursuant to federal law. This decision is notable in that it is at odds with a recent decision by the Second Circuit Court of Appeals in *Tribune*,[1] which held that state law constructive fraudulent conveyance claims brought by creditors are barred by the Bankruptcy Code's safe harbors.

Background

In 2007, private equity fund Water Street Healthcare Partners, L.P. ("Water Street") acquired Physiotherapy Holdings, Inc. (the "Debtor") for roughly $150 million. Shortly after the transaction closed, Water Street entered into an agreement to merge the Debtor with Benchmark Medical, Inc. Water Street owned 45% of the common stock of the surviving entity, while private equity fund Wind Point Partners IV, L.P. (together with Water Street, the "Defendants") held a 35% ownership stake. Throughout the next five years, the Defendants increased their ownership to approximately 90% of the Debtor's common shares.

The litigation trustee (the "Trustee")[2] alleges that during this time, the Defendants engaged in various forms of accounting fraud in order to overstate the Debtor's financial health and reap a substantial profit from the sale of their shares. By 2009, the Debtor's financial condition had deteriorated significantly, and, according to the Trustee, the Defendants began implementing new strategies to sell the company and maximize the potential sale consideration, including pressuring the Debtor's senior management into manipulating net revenue and patient visit counts to make the Debtor seem more profitable.[3]

1 *Deutsche Bank Trust Co. Ams. v. Large Private Beneficial Owners (In re Tribune Co. Fraudulent Conveyance Litig.)*, 818 F.3d 98 (2d Cir. 2016).

2 The Debtor established the PAH Litigation Trust through its plan of reorganization. Because the Secured Noteholders (defined below) assigned their individual claims to the Trustee, the Litigation Trust has standing to assert claims in the capacity of both an estate representative and an assignee.

3 Because the Defendants' representatives sat on the board, the Trustee asserted that Defendants were well aware of these accounting manipulations.

The winning bidder was private equity firm Court Square, with a cash offer of $510 million. Court Square created a subsidiary to merge into the Debtor, leaving the Debtor as the surviving entity. The subsidiary financed the transaction by issuing, among other things, $210 million in Secured Notes. According to the Trustee, the Secured Notes were marketed with an offering memorandum that falsely represented the Debtor's pre-tax net income and unadjusted EBITDA. Under the terms of the deal, the Debtor assumed the debt, and the Defendants received $248.6 million in exchange for their shares. Shortly after the transaction closed, the Debtor's new owner retained an accounting firm which determined that the Debtor's income had been overstated for the years 2010 and 2012. On April 2, 2014, the Debtor defaulted on the Secured Notes, and on November 12, 2013, the Debtor commenced a case under chapter 11 of the Bankruptcy Code.

The Trustee alleged that (i) the Defendants knew that their shares were grossly overvalued and (ii) the financial deterioration of the new company was inevitable once its new management uncovered the fraud. The Trustee filed an eight-count Complaint, which included intentional fraudulent transfer claims and federal and state law constructive fraudulent transfer claims, seeking to avoid the payments made to the Defendants for their equity in the Debtor. The Defendants argued, among other things, that the payments could not be avoided as constructive fraudulent transfers due to the applicability of the Bankruptcy Code's safe harbors, in particular section 546(e) of the Bankruptcy Code.[4]

Decision

The Bankruptcy Court spent the majority of its opinion considering whether section 546(e) of the Bankruptcy Code preempts state fraudulent transfer law with respect to the claims being asserted by the Trustee, considering three separate arguments advanced by the Trustee.

Preemption of Individual Creditor Claims

First, the Trustee argued that because section 546(e) only bars avoidance actions by an estate representative—and not a litigation trustee—the litigation trust may assert claims under state fraudulent transfer law, so long as such claims were assigned by creditors. The Defendants argued that section 546(e) preempts state fraudulent transfer law with respect to such claims.

The Bankruptcy Court agreed with the Trustee. In adopting the reasoning of the United States Bankruptcy Court for the Southern District of New York in *Lyondell*,[5] the Bankruptcy Court noted that the plain language of section 546(e) only limits a *trustee's* ability to bring a fraudulent conveyance action; the statute is silent, however, with respect to a

[4] Section 546(e) provides, in pertinent part: "Notwithstanding [S]ections 544 … [and] 548(a)(1)(B) ... the trustee may not avoid a transfer that is a … settlement payment … made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract … that is made before the commencement of the case, except under Section 548(a)(1)(a) of this title."

[5] *Weisfelner v. Fund 1 (In re Lyondell Chem. Co.)*, 503 B.R. 348 (Bankr. S.D.N.Y. 2014). The *Lyondell* court held that section 546(e) does not apply to individual creditors asserting fraudulent transfer claims under state law.

creditor's ability to bring such a claim. In contrast, Congress explicitly has stated in other Bankruptcy Code sections when it intends for a provision to apply to entities other than the trustee. Moreover, section 546(e) does not incorporate a phrase such as "notwithstanding any applicable law," which appears in other Code sections in order to expressly preempt state law.

Turning to the legislative history, the Bankruptcy Court noted that the purpose of the safe harbors is to mitigate the potential systemic risk of certain complex financial transactions. Under these facts, however, allowing the Trustee to pursue its state fraudulent transfer claims would not have a destabilizing effect on the financial markets Congress sought to protect through the safe harbors. The Trustee is not seeking to avoid a large portfolio of swaps, nor are any public shares involved. Instead, the Bankruptcy Court found that requiring two private equity funds (who owned over 90% of the Debtor's common stock) to disgorge their payments would hardly pose any sort of "ripple effect" to the broader secondary market. The Bankruptcy Court also agreed with the *Lyondell* bankruptcy court that the states traditionally have occupied the field of fraudulent transfer law, such that applying the presumption against federal preemption of state laws (absent clear Congressional intent to the contrary) is appropriate. Finally, the Bankruptcy Court noted that the Defendants were alleged to have acted in bad faith, stating that "[p]ermitting a defendant to evade liability in this scenario vis-à-vis the safe harbor would run counter to Congress' policy of providing remedies for creditors who have been defrauded by corporate insiders."

The Trustee also argued that because the Defendants' shares were converted into certificates prior to the merger's closing, the payments to selling shareholders were not "settlement payments" *in connection with* a "securities contract." The Bankruptcy Court disagreed. First, section 546(e) provides that the settlement payment must be made in connection with a securities contract, which standard was met here. Moreover, the Third Circuit previously has held that the definition of the term "settlement payment" was broad enough to encompass "the transfer of cash or securities made to complete a securities transaction."[6] As a result, the fact that the Defendants' shares were converted into certificates does not overcome the broad scope of section 546(e).

Based on the foregoing, the Bankruptcy Court held that a litigation trustee may assert state law fraudulent transfer claims in the capacity of creditor-assignee, when the transaction sought to be avoided poses no threat of ripple effects in the securities markets; the transferees received payment for non-public securities; and the transferees were corporate insiders that allegedly acted in bad faith.[7]

6 *Lowenschuss v. Resorts Int'l, Inc. (In re Resorts Int'l, Inc.)*, 181 F.3d 505, 515 (3d Cir. 1999).

7 Section 546(e) carves out an exception for intentional fraudulent transfers brought under section 548(a)(1)(A), but there is no such exception for constructive fraudulent transfer claims brought under section 548(a)(1)(B). The Trustee argued that the safe harbor did not apply to its claims because the transferees allegedly participated in the fraud, but the Bankruptcy Court held that, as the statute is currently written, there is no exception for insiders who allegedly acted in bad faith. Despite its holding, the Bankruptcy Court did note that where, as here, the Trustee alleges that the transferee actively participated in the fraud, the cases holding the safe harbor applicable to constructive fraudulent transfer claims—despite the debtor's involvement in the fraud—lose some persuasive value.

Remaining Arguments

The Defendants argued that because the Secured Noteholders were aware that the proceeds from the issuance would be used to cash out the selling shareholders, the noteholders ratified the fraudulent transfer when they purchased their securities and so are estopped from seeking to avoid the transfer. The Trustee argued that the Secured Noteholders could not have ratified the transaction, because they purchased the notes in reliance on fraudulent financial statements. The Bankruptcy Court found that the Trustee advanced sufficient allegations that the Secured Noteholders were misled into lending money to a company whose financial health was poorer than represented, and that based on these allegations it could not be concluded that the Secured Noteholders ratified the sale of the Debtor.[8]

The Defendants also argued that a release entered into by Court Square and the Defendants, eight months after the sale, prohibits the Trustee from asserting certain counts of the Complaint. In response, the Trustee argued that because avoidance actions are not derivative of a debtor's prepetition legal interests,[9] the release is unenforceable with respect to the Trustee's claims. The Bankruptcy Court held that because the Trustee is not a party to the release, he is not bound by the terms of the agreement.

Finally, the Bankruptcy Court held that the Trustee alleged more than the requisite number of "badges of fraud" to overcome Defendants' motion to dismiss with respect to the Trustee's actual fraudulent transfer claims. Specifically, the transferees were classic insiders of the Debtor, as they owned 90% of the Debtor's common stock; the complaint clearly alleged numerous accounting inaccuracies that could lead a reasonable finder of fact to conclude that the Debtor's shares were grossly overvalued; and there was a supportable inference that the Defendants intentionally manipulated the Debtor's earnings in order to maximize the proceeds for their shares.

Conclusion

Courts in New York have reached differing conclusions with respect to the applicability of the section 546(e) safe harbor to preempt state law fraudulent transfer claims, though cases in New York that held such claims could proceed are no longer good law in the Second Circuit based on the Second Circuit's recent decision in *Tribune*.[10] Here, the Bankruptcy Court relied heavily on the legislative history and Congressional intent with respect to section 546(e) in disagreeing with the policy concerns raised by the Second Circuit in *Tribune* (namely, that the safe harbors were enacted to promote finality for individual investors). Instead, the Bankruptcy Court argued that such cases have placed too much emphasis on certain themes that do not appear to have played a critical role in the drafting of the safe harbors, as opposed to focusing on the purpose of the safe harbors, which, according to the Bankruptcy Court, is to mitigate the potential systemic risk of certain complex financial transactions.

[8] Ratification is the act of knowingly giving sanction or affirmance to an act which otherwise would be unauthorized and not binding. The central element of ratification is intent, which the Bankruptcy Court found may not have been present based on these facts.

[9] Post-petition avoidance actions can only be brought by a trustee after a bankruptcy petition is filed, and the prepetition debtor does not own the right to pursue a fraudulent transfer claim in bankruptcy, nor can the prepetition debtor waive such claims.

[10] *See, e.g., Tribune*, 818 F.3d 98; *Lyondell*, 503 B.R. at 348; *Whyte v. Barclays Bank PLC*, 494 B.R. 196 (S.D.N.Y. 2013).

Despite its disagreement with the Second Circuit in *Tribune*, the Bankruptcy Court's holding is somewhat limited: a litigation trustee may assert state law fraudulent transfer claims in the capacity of creditor-assignee when avoidance would not threaten a ripple effect in the securities markets; the transferees received payment for non-public securities; and the transferees were corporate insiders that allegedly acted in bad faith. Though the holding certainly is notable, the limitations on its applicability may not make the safe harbor as unsafe as it might otherwise appear.

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