AMERICAN BANKRUPTCY INSTITUTE

VALCON 2022

Mitigating Fraudulent Transfer Risk

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AMERICAN BANKRUPTCY INSTITUTE
AIRA

Mitigating Fraudulent Transfer (and Other) Risks in a Levered Finance Transaction

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Agenda

1. **Who Are You Worried About?**
2. **What Are You Worried About?**
3. **Why Worry? We Have Defenses!**
4. **How Do You Mitigate the Risk on the Front End?**
5. **Market Forces and the Impact of Hindsight**
6. **Q&A**

Case Studies

Global EPC and Tech Services Company:

1. Tuck-In LBO of much larger E&C Company
   a. E&C Company has had award, backlog, sales deterioration, and significant cost overruns due to fixed lump sum contracts
   b. Acquired Company 'urged' to sell due to broken compliance covenants, large current debt balance, and liquidity
   c. LBO assumes significant EBITDA 'one-time' addbacks (including adding back project charges) and large undistinguished run-rate synergies
   d. Working Capital need of Acquiree already stressing NewCo

Telecom Company:

1. Growing Financial Pressure on Free Cash Flow and EBITDA
   a. Spin off of 'crown jewel' asset(s) - 80% of proceeds distributed to shareholders while only 20% to retire debt
      i. How does a stock dividend alleviate its financial pressure? What really was intent?
      ii. In addition, leaves Company with large annual 'lease' payments
      iii. Finally, some irregularities on financial statements between RemainCo and SpinCo
   b. RemainCo undercapitalized, margins continue deterioration with large lease payment, and necessary capital improvements made by RemainCo for SpinCo with no additional consideration

1. Who Are You Worried About?

a. **Shareholders**

b. **Capital Provider**

c. **Directors**

d. **Other Stakeholders**

2. What Are You Worried About?

a. **Lien/Claim Avoidance**

b. **Improper Dividends**

c. **Breach of Fiduciary Duty**

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2(a). Lien/Claim Avoidance

Constructive Fraudulent Transfer (under Bankruptcy Code)

- Trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, if the debtor received less than reasonably equivalent value; and

  (i) was insolvent as a result of such transfer or obligation;
  (ii) was engaged in business or a transaction, or was about to engage in business or transaction, for which any property remaining with the debtor was an unreasonably small capital;
  (iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or
  (iv) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business." § 548(a)(1)(B)

Actual Fraudulent Transfer (under Bankruptcy Code)

- Trustee may avoid any transfer . . . of an interest of the debtor in property, or any obligation . . . incurred by the debtor . . . if the debtor . . . made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted." § 548(a)(1)(A)

- Trustee also authorized to avoid transfers voidable under state fraudulent transfer law. § 544(b)

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2(b). Improper Dividends

A company borrows money and makes distributions to the equity investors, raising potential personal liability for directors if distributions were unlawful.

- Joint and several liability for a Delaware corporation director for "wilful or negligent" issuance of unlawful dividends while a director. *DGCL § 174(a).*
  - Corporations may only pay dividends out of their statutory surplus or, if there is no surplus, out of the corporation's net profits for the fiscal year in which the dividend is declared or the preceding fiscal year. *DGCL § 170.*
  - If the corporation has dissolved or is insolvent, claim permitted by the corporation's ***creditors***. *DGCL § 174(a). "*Creditors" only requires that a person "*have a claim*" (even if unliquidated) at the time of the allegedly unlawful dividend. *JPMorgan Chase Bank, N.A. v. Ballard*, 213 A.3d 1211, 1216 (Del. Ch. 2019).
- Directors will be "fully protected" if the directors relied in good faith on the corporation's records or on appropriate officers of the corporation and outside experts. *DGCL § 172*. The company's certificate of incorporation cannot exculpate directors from this liability. *DGCL §* 102(b)(7).
  - Best practice is to obtain opinion of statutory surplus by qualified outside financial advisor who is retained upon review of counsel, and corroborated by certification of CFO.
  - This may be especially important when the nature of assets or liabilities is complicated. *See In re The Chemours Co. Derivative Litigation*, 2021 WL 5050285 (Del. Ch. Nov. 1, 2021) (directors were not liable for failing to depart from GAAP in connection with calculating surplus with contingent liabilities, and where they made decisions after consulting with the company's management and financial advisors, after receiving relevant presentations)

Highlights

Who may be liable: Directors at time of dividend who were present and did not dissent.

Who may sue: Company or its creditors (if company insolvent or dissolved)

Statute of Limitations: 6 years from time of payment of unlawful distribution

2(c). Breach of Fiduciary Duty

In re Nine West LBO Securities Litigation, 505 F. Supp. 3d 292 (S.D.N.Y. 2020)

- Board of directors unanimously approved LBO transaction, which included a $1.2 billion distribution to shareholders. However, before closing, buyer changed deal terms and reduced its planned equity contribution from $395 million to $120 million, and Nine West also increased the total amount of new debt from $1.2 billion to $1.55 billion.
- While the board investigated and considered the fairness of the proposed $1.2 billion distribution, it allegedly did not consider the fairness and impact of the additional debt on the post-merger company or the carve-out sale of certain business units on Nine West's solvency and financial condition.
- The merger closed in April 2014, and four years later, Nine West filed for bankruptcy. Litigation trustee sue directors and officers for, among other claims, breach of fiduciary duty and aiding and abetting breach of fiduciary duty, arising from the LBO.
- District Court denied a motion to dismiss the claims against the directors, finding that the directors failed to conduct a reasonable investigation into whether the transaction "as a whole" would render the company insolvent.

3. Why Worry? We Have Defenses!

a. **Good Faith and Good Faith Transferees**

b. **Section 546(e) and Preemption**

c. **Ratification and Consent**

3(a). Good Faith and Good Faith Transferees

Bankruptcy Code Section 548(c)

"Except to the extent that a transfer or obligation voidable under this section is voidable under section 544, 545, or 547 of this title, a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation."

- Transferee must show both value and good faith.
- "Value" defined in Bankruptcy Code section 548(d)(2)(A) as "property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or a relative of the debtor."
- "Good faith" is not defined in the Bankruptcy Code. *See Jimmy Swaggart Ministries v. Hayes (In re Hannover Corp.)*, 310 F.3d 796, 800 (5th Cir. 2002) ("[T]here is little agreement among courts as to what conditions ought to allow a transferee [the good-faith] defense. This is not surprising, as the variables are manifold.").

3(b). Section 546(e) and Preemption

Bankruptcy Code Section 546(e)

"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 (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, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title."

Preemption of State Law Fraudulent Transfer Claims

- In *Deutsche Bank Trust Co. Ams. v. Large Private Beneficial Owners (In re Tribune Co. Fraudulent Conveyance Litig.)*, 818 F.3d 98 (2d Cir. 2016), the Second Circuit held that Bankruptcy Code section 546(e)'s safe harbor preempted claims under state law to avoid pre-bankruptcy payments to shareholders as fraudulent transfers.
- In April 2021, the U.S. Supreme Court declined to hear the appeal of the *Tribune* decision.

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3(c). Ratification and Consent

- An affirmative defense that the party seeking to avoid a transaction as a fraudulent transfer was a participant in (or consented to) the transaction, and, therefore, cannot seek to have the transaction avoided.
- "Creditors who authorized or sanctioned the transaction, or, indeed, participated in it themselves, can hardly claim to have been defrauded by it, or otherwise be victims of it." *Weisfelner v. Fund 1 (In re Lyondell Chem. Co.)*, 503 B.R. 348, 383 (Bankr. S.D.N.Y. 2014).

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4. How Do You Mitigate the Risk on the Front End?

a. **Diligence**
   1. **Red Flags**

b. **Representations, Warranties, and Other Documentation Terms**

c. **Solvency Certificates**

d. **Third Party Input**
   1. **Projections**
   2. **Valuations and Appraisals**
   3. **Fairness Opinions**

4(a). Diligence

Best Practices:

1. Financial condition due diligence
    a. Financial projections by management and advisor(s) (expert), including GAAP basis and market balance sheet
    b. Lender insolvency analysis of each borrower, guarantor, grantor, as well as on consolidated basis (*In re Tousa*)

Red Flags:

1. Multiple sets of projections
2. Operational reorganizations and transaction synergies (buy-out)
3. Restricted access to portfolio company, all communications through equity sponsor
4. Prior bankruptcy filing—was it a balance sheet or operational issue?
5. Management's experience in operating a highly leveraged company
6. Company unable to generate basic reports from its accounting and other systems
7. Customer concentrations
8. Projected and persisting margin and growth rates materially better than competitors

4(b). Representations, Warranties and Other Documentation Terms

Best Practices:

1. Loan Documentation – Careful Drafting
    a. Representations (supported by board resolutions/minutes)
    b. Loan Covenants
    c. Financial Covenants
    d. Conditions Precedent
    e. Savings Clauses
    f. Net Worth Guaranties
    g. Subrogation
    h. Contribution Rights

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4(c). Solvency Certificates

1. Consider conflicts of interest of person providing certificate (e.g., CFO):
   a. Transaction participant?
   b. Will be analyzing own projections?
2. Cost considerations
   a. Modest inconvenience relative to board member liability
   b. Fraudulent transfer cases costly—solvency opinion may help mitigate cost or litigation altogether
3. Easier to evaluate subject company concurrent with transactions, instead of retrospectively years later
4. Company's willingness to allow independent solvency analysis—"nothing to hide"
5. Qualifications
   a. Generally, CFOs have not been trained to conduct solvency analysis
   b. Relatively small universe of finance professionals have significant experience in providing such opinions

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4(c). Solvency Certificates (cont'd)

Solvency Certificates (Relevant Cases)

1. *In re Waccamaw's HomePlace*, 325 B.R. 524, 530 (Bankr. D. Del. 2005) (rejecting solvency testimony of defendant's CFO as "superficial at best and insufficient to overcome the presumption").
2. *Peltz v. Worldnet Corp. (In re USN Comm'ns, Inc.)*, 280 B.R. 573, 585 n.19 (Bankr. D. Del. 2002) ("Defendant has presented no expert testimony to rebut the presumption of Debtor's insolvency. . . . [T]he issue here is whether Plaintiff should be forced to proceed with the burden of proving Debtor's insolvency for the purposes of § 547(b) where the only evidence submitted by Defendant to rebut the § 547(f) presumption of insolvency is the Form 8-K. I find that he should not." (emphasis in original)).
3. *Brandt v. Samuel, Son & Co., Ltd. (In re Longview Aluminum, L.L.C.)*, Case No. 03 B 12184, 2005 Bankr. LEXIS 1312, at *17 (Bankr. N.D. Ill. July 14, 2005) ("It is generally accepted that whenever possible, a determination of insolvency should be based on seasonable appraisals or expert testimony.").
4. *Miller & Rhoads, Inc. Secured Creditors' Trust v. Robert Abbey, Inc. (In re Miller & Rhoads, Inc.)*, 146 B.R. 950, 956 (Bankr. E.D. Va. 1992) ("Numerous cases have held that the schedules are not dispositive or controlling and that courts should rely upon more accurate evidence, such as current appraisals, opinion testimony or actual sales of the assets in determining insolvency." (citation omitted)).

4(d). Third Party Input

1. Projections
    1. Internal sources and advisors.

2. Valuations and Appraisals
    1. Confirm by valuation or appraisal that the Company is solvent and will not be left with unreasonably small capital following transaction.

3. Fairness Opinions
    a. Provides an opinion as to whether proposed terms are fair to the Company.
    b. Serves as evidence that reasonably equivalent value was provided.

5. Market Forces and the Impact of Hindsight

1. Recent Trends
    a. Quick Transactions: Deal timeline may not allow for third-party valuations or solvency/fairness opinions.
    b. Uncertainty: Current global and economic conditions may heighten valuation disputes.

2. Hindsight Rule
    a. *In re W.R. Grace & Co.*, 281 B.R. 852 (Bankr. D. Del. 2002)
        a. Subsequent historical information may be used to determine an accurate calculation of the liability for insolvency calculation
        b. Use of hindsight to estimate disputed claim

    b. *In re Semcrude L.P.*, 2016 WL 1697085 (3d Cir. Apr. 28, 2016)
        a. Hindsight should not be used to answer the question of unreasonably small capital
        b. To rely on hindsight would "improperly expand fraudulent conveyance law far beyond its proper borders."

6. Q&A

Faculty

Katherine R. Catanese is an equity partner in the bankruptcy and restructuring group at Foley & Lardner LLP in New York, where she assists troubled companies facing critical points in their businesses related to financial distress and restructuring, including maximizing the value of their assets through both in- and out- of court asset sales. She also focuses her practice on helping creditors solve problems related to all aspects of distressed debt, which has has included representing debtors, lenders and strategic buyers in Article 9 sales and assignments for the benefit of creditors. Ms. Catanese also represents investors and other parties in fraud-based litigation arising in the insolvency space; this includes various cross-border fraud matters and representation of investors and managers in hedge funds both onshore and offshore in bankruptcy ligation including involuntary bankruptcies and chapter 15 bankruptcies. In that regard, she focuses her practice on representation of court-appointed receivers in Chinese reverse-merger cases where the U.S. entity has "gone dark" and returned to China, leaving their U.S. investors without recourse. These cases often involve Cayman and BVI litigation and negotiations as the subsidiaries of these companies are often located there. In addition, Ms. Catanese focuses on for-profit schools and higher education restructuring generally, with an emphasis on fraud investigation and intervention. She is building a practice focusing on representing higher-education institutions, lenders and private-equity funds in all forms of litigation related to their business and financial restructuring of these schools. She also represents banks and trustees of bank holding companies, including litigation related to procurement of tax refunds and disputes with the FDIC over refund ownership. She further emphasizes her practice on the representation of creditors, creditors' committees and indenture trustees. Ms. Catanese has experience in the representation of trustees regarding resolution and objection to bankruptcy claims, pursuit of fraudulent transfer and preference actions, and litigation related to bad-faith bankruptcy filings, Ponzi schemes, § 363 sales and e-discovery in bankruptcy cases. She is a member of the Bankruptcy and Health Care Restructuring sub team at Foley and is the women's network coordinator for Foley's Women's Network in the New York office. Prior to joining Foley, Ms. Catanese was an associate at Allard & Fish, P.C., where she represented a chapter 7 trustee and corporate debtors, secured and unsecured creditors, and trustees in all aspects of bankruptcy litigation. She received her B.A. in psychology *summa cum laude* in 2001 and her J.D. *cum laude* in 2004 from Michigan State University. During law school, she clerked for Hon. David L. Jordon.

Charles A. Dale is a partner with Proskauer PC's Corporate Department in Boston and a member of both its Business Solutions, Governance, Restructuring & Bankruptcy and Private Credit Restructuring Groups. He has 30 years of experience in corporate reorganizations and debt restructurings. As a member of the Private Credit Restructuring Group, Mr. Dale's practice focuses on direct lenders and ad hoc groups of direct lenders, hedge funds and BDCs. He also represents troubled companies, equity sponsors, creditors' committees, trustees and receivers in complex out-of-court debt restructurings and formal insolvency proceedings. He has also served as a court-appointed chapter 11 trustee and frequently represents purchasers of financially distressed businesses. Mr. Dale has handled debt restructurings, reorganizations and distressed-asset transactions. He is recognized by *Chambers USA* in Band 1 of its rankings, is a Fellow of the American College of Bankruptcy and has been named "Lawyer of the Year" three times since 2015 by *U.S. News Best Lawyers*. He has also been recognized as one of the top 100 lawyers in New England since 2008. Mr. Dale has written articles and

spoken frequently on a wide range of matters, including debtor-in-possession financings, health care restructurings, intellectual property licensing in bankruptcy, executory contracts, director and officer liability, and income and property taxation in bankruptcy. He received his B.S. with honors from the University of Dayton and his J.D. from Northeastern University School of Law.

Rob Dugger is a director at Vibrant Capital Partners in New York, where he leads special-situations and workout efforts for Vibrant-managed CLOs and Vibrant's structured credit hedge fund and SMA offerings. Additionally, he conducts credit analysis for its Syndicated Credit Team. Mr. Dugger has 11 years of experience advising and investing in the restructuring industry. Previously, he was a distressed-debt analyst and high-yield/leveraged-loan desk analyst at Morgan Stanley. Mr. Dugger began his career in investment banking, focusing on restructuring advisory at Alvarez & Marsal and Lazard. He received his B.S. in economics with dual concentrations in finance and strategic management from the Wharton School at the University of Pennsylvania.

Benjamin W. Loveland is a partner in WilmerHale's Bankruptcy and Financial Restructuring Practice Group in Boston. His practice focuses on the representation of distressed-debt investors in chapter 11 bankruptcy proceedings and other financial restructurings. Mr. Loveland routinely represents indenture trustees, agents, noteholders and lenders in large and complex bankruptcy cases and resulting litigation. He also has deep experience assisting clients with pre-investment diligence and transaction structuring against the insolvency background, and has helped borrower clients with refinancing and restructuring transactions. Mr. Loveland rounds out his practice with extensive knowledge of cross-border insolvency matters, distressed sales, and issues involving the intersection of bankruptcy and intellectual property law. He previously clerked for Hon. Joel B. Rosenthal (ret.) of the U.S. Bankruptcy Court for the District of Massachusetts. Mr. Loveland received his B.A. *cum laude* from Providence College in 2004 and his J.D. *magna cum laude* from Suffolk University Law School in 2007.

Michael T. Sullivan is managing principal of MTS Advisory LLC in New York. An experienced investor, owner and advisor, he has spent his career executing and managing transactions and processes in complicated, dynamic and contentious situations, with a focus on successful outcomes that maximize return and reduce risk. Mr. Sullivan serves as an independent director for companies undergoing financial restructurings, M&A processes and other operational turnarounds. He takes a hands-on approach, typically leading special committees and working closely with management and stakeholders to help guide a company through difficult circumstances. Prior to launching his advisory firm in 2017, Mr. Sullivan was managing director in the distressed securities group at Angelo, Gordon & Co. and worked in the restructuring group at UBS Investment Bank, where he advised both companies and creditors in large complex restructurings. He received his A.B. from Bowdoin College, his M.B.A. from the Tuck School of Business at Dartmouth and his M.A.L.D from the Fletcher School of Law and Diplomacy at Tufts University.