WEIL GOTSHAL

Private Equity Alert

May 2010

Weil News

- Weil Gotshal expanded its funds practice in Asia by adding fund formation partner John Fadely to its Hong Kong office
- Weil Gotshal lawyers Joe Basile, Ron Landen and Rose Constance were awarded a Burton Award for Legal Writing for their article "Equitable (In)subordination – Considerations for Sponsors Lending to Portfolio Companies" which first appeared in the September 2009 issue of our Private Equity Alert
- Weil Gotshal advised Oak Hill Capital in connection with its $570 million acquisition of restaurant and entertainment chain Dave & Busters
- Weil Gotshal advised Lee Equity Partners in connection with its acquisition of "take and bake" pizza chain Papa Murphys
- Weil Gotshal advised OMERS Private Equity in connection with its acquisition of United States Infrastructure Corporation, a provider of locating and marketing services for underground utilities
- Weil Gotshal advised Advent International on its acquisition of DFS Furniture Company, the UK's leading sofa retailer
- Weil Gotshal advised Advent International on its sale of Poundland, Europe's largest single price discount retailer
- Weil Gotshal advised Hg Capital in its acquisition of Frosunda, a Swedish disability care services company

Caveat Vendor – Mitigating Fraudulent Conveyance Risk

By Ilkka Perheentupa (ilkka.perheentupa@weil.com) and Jonathan L. Sagot (jonathan.sagot@weil.com)

In this past economic downturn, an increasing number of private equity sponsors have seen their portfolio company sales come under challenge on the basis of an alleged fraudulent conveyance. Many highly leveraged capital structures associated with pre-recession LBOs proved unsustainable in the down-cycle and the ensuing restructurings and bankruptcies led creditors and debtors in possession to seek to recover payments made to selling shareholders as part of the LBO — in many cases years after the transaction closed.

The federal Bankruptcy Code empowers the debtor in possession to avoid pre-bankruptcy transfers where the debtor did not receive reasonably equivalent value for the transfer and was left insolvent, unable to pay its debts or with unreasonably small capital as a result of the transaction. States also have fraudulent transfer statutes that often provide for longer time periods to bring avoidance claims than the Bankruptcy Code. In the LBO context, bankruptcy trustees often take advantage of these longer claim periods and bring fraudulent transfer claims under the relevant state law.

What can selling sponsors do to mitigate the risk of successful post-LBO fraudulent conveyance claims? Sponsors should consider at least the following when planning and structuring their sale transactions:

- **Due Diligence of Post-LBO Capital Structure.** Selling sponsors should conduct an independent due diligence of the contemplated post-LBO capital structure of the target entity to evaluate the solvency of the target post-closing, the ability of the target to service its debt obligations and the sufficiency of the contemplated capital cushion.
- **Analysis of Roll-Over Liabilities.** Selling sponsors should also analyze the pre-closing liabilities that will be rolled over as part of the transaction. Under the laws of certain states, the success of a fraudulent transfer claim may depend on the existence of creditors pre-dating the LBO transaction who can establish they were harmed by the transaction.
- **Solvency Representations, Certificates and Opinions.** Although solvency representations, certificates and opinions cannot eliminate fraudulent conveyance risk, they can force the buyers to analyze the post-LBO capital structure from a solvency perspective and provide more relevant disclosure to the sellers in this regard. Solvency opinions from sophisticated third-party experts

may also be persuasive for purposes of the court's factual analysis.

- **Settlement Payments Defense.** Selling sponsors should seek to structure a sale to increase the likelihood that the transaction would receive the benefit of the so-called "settlement payments" defense, a safe harbor provision codified in Section 546(e) of the Bankruptcy Code that bars avoidance of certain transfers made by the debtor before the bankruptcy case is filed.

Settlement Payments

Section 546(e) of the Bankruptcy Code provides that the bankruptcy trustee "may not avoid a transfer that is a…settlement payment…made by or to (or for the benefit of) a…stockbroker, financial institution, financial participant, or securities clearing agency, …that is made before the commencement of the case…." The somewhat circular wording of Section 741(8) of the Bankruptcy Code defines "settlement payment," in relevant part, as a "…settlement payment, or any other similar payment commonly used in the securities trade."

Federal courts have routinely held that Section 546(e) insulates payments to selling shareholders from an avoidance claim in the context of *public* LBOs. However, courts have been divided as to whether or not the statute should apply to *private* LBO transactions and on the requisite level of involvement of the *financial institution* in processing the payments at issue.

Public vs. Private

Relying on a literal interpretation of the statute, the Third Circuit (whose jurisdiction includes Delaware), the Sixth Circuit and the Eighth Circuit[1] have each held that the term "settlement payment" should be interpreted broadly to encompass transfers of money or securities made to complete a securities transaction. According to these circuit courts, payment for shares in an LBO is a "common securities transaction" and therefore a "settlement payment" for the purposes of Section 546(e). As a result, these circuit courts concluded that regardless whether the target company is privately held or publicly traded, the use of a financial institution to facilitate payment of the purchase price in the context of an LBO protects such payments from subsequent fraudulent conveyance claims under Section 546(e).

Selling sponsors should seek to structure purchase price payments as "settlement payments" under the Bankruptcy Code.

These circuit courts have rejected the reasoning employed by lower federal courts in Texas and New York,[2] each of which relied on the legislative history of Section 546(e) to hold that the settlement payments defense was not intended by Congress to apply to private LBOs.

While several other circuit courts (including the Second Circuit whose jurisdiction includes New York) have yet to address the applicability of the settlement payments defense in the context of a private LBO, sponsors should take comfort in the decisions from the Third, Sixth and Eighth Circuits. Notably, with a case called *In re Plassein*, the Third Circuit settled the law in Delaware, the jurisdiction most frequently encountered by private equity sponsors.

We note, however, that the U.S. Bankruptcy Court for the District of Delaware recently denied a motion to dismiss an adversary proceeding in a case called *In re Mervyn's Holdings, LLC, et al.*[3] and held that the settlement payments defense did not apply in an LBO transaction where a series of conveyances were deemed to form part of a single integrated scheme of transactions that the court "collapsed" into a single transaction. The *Mervyn's* court concluded that the plaintiff in *Mervyn's* alleged actual fraud (not constructive fraud as in other LBO fraudulent transfer cases) and rejected the settlement payments defense as not all of the "collapsed" conveyances constituted settlement payments (in this case, the LBO included a separate transfer of real estate assets for virtually no consideration).

Role of the Financial Institution

These recent cases also provide guidance as to how involved a financial institution must be for the settlement payment defense to apply. In the Third Circuit's *In re Plassein* decision, the selling shareholders delivered their shares directly to the acquiror and the court concluded that a bank's facilitation of a wire transfer alone was sufficient. The other courts did not go so far; rather the Sixth and Eighth Circuits concluded that the bank's role as exchange agent or escrow agent was sufficient. Importantly, each of these circuit courts expressly rejected a precedent from the Eleventh Circuit which required a financial institution to acquire a beneficial interest in the LBO consideration to qualify under Section 546(e).

Conclusions

By conducting proper due diligence and negotiating and structuring the transaction with a keen eye toward the solvency of the surviving entity post-closing, selling sponsors can seek to reduce the risk of successful post-LBO fraudulent conveyance claims. Selling sponsors should also

work with their counsel to seek to structure purchase price payments as "settlement payments" under the Bankruptcy Code.

Although federal courts have set forth different standards regarding the requisite role of the financial institution in an LBO transaction, selling sponsors should consider providing that a financial institution be engaged to serve as an exchange or paying agent on the transaction. It should be noted, however, that courts can reject structures that are intended to abuse the "settlement payments" safe harbor. The payment structure must be one that is commonly used in securities transactions.

1 *In re Plassein Int'l Corp. (In re Plassein)*, 590 F.3d 252 (3d Cir. 2009); *QSI Holdings, Inc. v. Alford (In re QSI Holdings)*, 571 F.3d 545 (6th Cir. 2009); *Contemporary Indus. Corp.*, 564 F.3d 981 (8th Cir. 2009).

2 *Jewel Recovery, L.P. v. Gordon*, 196 B.R. 348, 352–53 (N.D. Tex. 1996); *Official Committee of Unsecured Creditors of Norstan Apparel Shops, Inc. v. Lattman (In re Norstan Apparel Shops, Inc.)*, 367 B.R. 68, 76 (Bankr. E.D.N.Y. 2007).

3 *Mervyn's LLC v. Lubert-Adler Group IV, LLC, et al. (In re Mervyn's Holdings, LLC)*, 2010 WL 980274 (Bankr. D. Del. March 17, 2010).

Back Issues of Private Equity Alert are available online at www.weil.com

Recent Articles:

Update on EU Proposal To Regulate Private Equity Fund Managers

New SEC Proxy Disclosure Rules Reach Certain Privately-Held Portfolio Companies

UK Takeover Code Makes Changes Related to Management Incentives

Tax Changes in Asia Pacific May Adversely Impact Private Equity Investment

Is Your Earnout Headed For A Burnout?

Shaken, Not Broken

House of Representatives Passes Carried Interest Legislation

Foreign Account Tax Compliance Act of 2009

Fair Is In the Eye of the Beholder

House Committee Clears Hurdle in Requiring Registration of Private Fund Managers

Private Equity Alert is published by the Private Equity Group of Weil, Gotshal & Manges LLP, 767 Fifth Avenue, New York, NY 10153, +1-212-310-8000. The Private Equity Group's practice includes the formation of private equity funds and the execution of domestic and cross-border acquisition and investment transactions. Our fund formation practice includes the representation of private equity fund sponsors in organizing a wide variety of private equity funds, including buyout, venture capital, distressed debt and real estate opportunity funds, and the representation of large institutional investors making investments in those funds. Our transaction execution practice includes the representation of private equity fund sponsors and their portfolio companies in a broad range of transactions, including leveraged buyouts, merger and acquisition transactions, strategic investments, recapitalizations, minority equity investments, distressed investments, venture capital investments and restructurings.

Founding Editor: Doug Warner (doug.warner@weil.com), +1-212-310-8751

Editor: Michael Weisser (michael.weisser@weil.com), +1-212-310-8249

©2010. All rights reserved. Quotation with attribution is permitted. This publication provides general information and should not be used or taken as legal advice for specific situations that depend on the evaluation of precise factual circumstances. The views expressed in these articles reflect those of the authors and not necessarily the views of Weil, Gotshal & Manges LLP. If you would like to add a colleague to our mailing list or if you need to change or remove your name from our mailing list, please log on to http://www.weil.com/weil/subscribe.html or e-mail subscriptions@weil.com.

Beijing
Steven Xiang
+86-10-8515-0558

Boston
James Westra
+1-617-772-8377

Budapest
David Dederick
+1-361-302-9100

Dallas
Glenn West
+1-214-746-7780

Dubai
Joe Tortorici
+971-4-4019650

Frankfurt
Gerhard Schmidt
+49-69-21659-700

Hong Kong
Akiko Mikumo
+852-3476-9008

Peter Feist
+852-3476-9100

London
Michael Francies
+44-20-7903-1170

Marco Compagnoni
+44-20-7903-1547

Munich
Gerhard Schmidt
+49-89-242430

New York
Barry Wolf
+1-212-310-8209

Doug Warner
+1-212-310-8751

Paris
David Aknin
+331-44-21-9797

Prague
Karel Muzikar
+420-2-2140-7300

Providence
David Duffell
+1-401-278-4700

Shanghai
Steven Xiang
+86-21-6288-1855

Silicon Valley
Craig Adas
+1-650-802-3020

Warsaw
Pawel Rymarz
+48-22-520-4000

Washington, DC
Robert Odle
+1-202-682-7180

Wilmington
E. Norman Veasey
+1-302-656-6600

www.weil.com