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Structuring a Sale of Privately-held Stock to Reduce Fraudulent-transfer Claims Risk

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Feature

Every once in a while, a court decision changes how a lawyer transacts business for a client. This article discusses in depth one such case, *Contemporary Indus. Corp. v. Frost,*[1] decided by the Eighth Circuit on April 29, 2009. A case addressing the identical issues, and reaching the same conclusion, was decided by the Sixth Circuit on July 6, 2009, in *QSI Holdings Inc. v. Alford (In re QSI Holdings Inc.).*[2] These cases should change how lawyers think about—and in many cases structure—the sale of a business that can be accomplished through a sale of stock in a privately-held company.

The Contemporary Industries *Decision*

Irving E. Walker

In *Contemporary Industries,* the shareholders of Contemporary Industries, a privately-owned corporation that operated convenience stores in the Midwest, sold their shares to an outside group of investors.[3] The investors borrowed a significant amount of the purchase price and pledged the company's assets as collateral for the loan, as part of a transaction generally known as a leveraged buyout (LBO).[4] The money to be used for the stock purchase, $26.5 million, and the shares themselves were deposited into a bank, and the parties entered into an escrow agreement governing the payment of the purchase price to the sellers.[5] Less than three years after the sale, Contemporary Industries filed a voluntary petition for relief under chapter 11 in the U.S. Bankruptcy Court for the District of Nebraska. The debtor maintained that its bankruptcy was a direct consequence of the debt load undertaken by the company in the LBO and filed an adversary proceeding against the former shareholders pursuant to the trustee's strong-arm powers under §544, alleging that the payments to the shareholders were fraudulent transfers under the Nebraska Uniform Fraudulent Act.[6] The lawsuit also sought relief under state law theories of unjust enrichment and excessive and/or illegal shareholder distributions.[7]

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The defendant stockholders moved for summary judgment on the grounds that the payments they received from the LBO were exempt from avoidance under §546(e) of the Bankruptcy Code, which provides, in relevant part, that "[n]otwithstanding §544, 545, 547, 548(a)(1)(B) and 548(b) of this title, the trustee may not avoid a transfer that is a...settlement payment, as defined in section...741 of this title, made by or to a...financial institution...that is made before the commencement of the case, except under 548(a)(1)(A) of this title."[8] The bankruptcy court agreed with the defendants and granted summary judgment in favor of the former stockholders.

The U.S. District Court for the District of Nebraska affirmed the bankruptcy court's decision, and the Eighth Circuit affirmed the district court.[9] In affirming the district court's ruling, the Eighth Circuit held that the payments at issue were "settlement payments" made to, and then by, a financial institution, thereby falling within the exemption to avoidance under §546(e).[10]

1 *Contemporary Indus. Corp. v. Frost,* 564 F.3d 981 (8th Cir. 2009).
2 *QSI Holdings Inc. v. Alford (In re QSI Holdings),* --- F.3d ---, 2009 WL 1905237 (6th Cir. July 6, 2009).
3 564 F.3d at 983.
4 *Id.*
5 *Id.*
6 *Id.* at 983-84. The lawsuit did not seek to avoid the transfers under §548 because the payments were made prior to one year before the filing date (the then-applicable time period for challenging fraudulent transfers under the Bankruptcy Code, which was extended to two years under BAPCPA). 11 U.S.C. §548(a)(1).
7 *Id.* at 984. The bankruptcy court held that the state law claims were preempted by §546(e). This article does not address the preemption doctrine or the appropriateness of the bankruptcy court's conclusion with respect to the application of the preemption doctrine in this case.
8 *Id.* at 984. As noted by the court, §564(e) has been amended several times since the 1999 version applicable to the case; however, the elements of the statute as applied in this case and discussed here are the same.
9 *Id.*
10 *Id.* at 989.

Diverging Views on the Scope of §546(e)

To qualify for the exemption from avoidance under §546(e), a seller of privately-held stock must show that the payment received for the stock (1) is a "settlement payment" within the meaning of §741(8) of the Code and (2) was made by or to (or for the benefit of) a financial institution.[11] Courts that have considered the issue have reached different conclusions regarding the meaning and breadth of these two requirements.

The "Settlement Payment" Requirement

Settlement payment is defined in §741(8) as "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade."[12] Prior to the Eighth Circuit's decision in *Contemporary Industries*, no circuit court had specifically addressed whether a settlement payment could include a payment made for privately-held stock, and there was a split among lower courts as to the applicability of §741(8) to private stock. The majority of reported bankruptcy and district court decisions adopts the view that "settlement payment" in §741(8) is limited to publicly-traded securities and does not apply to the sale of private stock.[13] Courts of this view generally find that §741(8) is ambiguous, and some have gone so far as to characterize the definition as unhelpful and circular, saying nothing more than "a settlement payment is a settlement payment."[14] As a result, either of perceived ambiguity or the risk of creating an absurd result, or both, these courts rely on congressional intent in reaching their conclusion that §546(e) only applies to public stock sales.

As recognized by the majority view, the purpose of §546(e), adopted in 1982, is "to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries," and to prevent "the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market."[15] Courts holding that §546(e) cannot apply to a private-stock sale state that Congress intended to protect the clearing and settlement system used in the securities industry, in which "parties use intermediaries to make trades of public stock which are instantaneously credited, but in which the actual exchange of stock and consideration... takes place at a later date," known as the settlement date.[16] These courts also raise a public policy concern that, if the statute were interpreted to include private-stock sales, the statute "would, essentially, convert that statutory provision into a blanket transactional cleansing mechanism for any entity savvy enough to funnel payments for the purchase and sale of privately held stock through a financial institution."[17]

Constituting a minority among reported decisions, other courts take the contrary view that "settlement payment" can include a payment of money or other consideration for private stock.[18] Courts adopting this approach define a settlement payment generally as "the transfer of cash or securities made to complete a securities transaction."[19] Applying a "plain meaning" approach, courts holding that §546(e) applies to private-stock sales find that nothing in the statute distinguishes between public and private stock sales, and that the application of §546(e) to private stock sales would not lead to an absurd result under principles of statutory construction.[20]

The Eighth Circuit adopted this minority view in *Contemporary Industries,* relying on the same reasoning as the lower courts, but relied most heavily on decisions from the Third, Ninth and Tenth Circuits, holding that "§741(8) is 'extremely broad' and intended to encompass most payments that can be considered settlement payments."[21] Although the other circuit courts did not specifically address whether §741(8) applies to private-stock sales, the Eighth Circuit relied on the broad interpretation of the statute by its sister courts to reach this conclusion.

Less than three months after *Contemporary Industries,* on July 6, 2009, the Sixth Circuit in *QSI Holdings,* a case involving a similar private LBO, agreed with the Eighth Circuit and held that §546(e) was not limited to public stock.[22] Although the Sixth Circuit agreed with the Eighth Circuit's holding, the court in *QSI Holdings,* in *dictum,* distinguished another case relied on by the plaintiff, *In re Norstan Apparel Shops Inc.,*[23] from the case at bar based on the fact that *Norstan* involved two shareholders of a Subchapter S corporation, and therefore did not "implicate public securities markets, and lacked many of the transactions 'commonly used in the securities trade.'"[24] Accordingly, it may be argued that the Sixth Circuit's decision does not expand the application of §546(e) as broadly as the Eighth Circuit, and is limited to private companies with a substantial number of shareholders.

The "Financial Institution" Requirement

Prior to *Contemporary Industries,* there were two circuit court decisions that addressed the second requirement of §546(e)—that the transfer be "made by or to (or for the benefit of) a...financial institution."[25] In *Munford v. Valuation Research Corp. (In re Munford Inc.),* the Eleventh Circuit held that funneling a settlement payment through a bank did not satisfy the "financial institution" requirement of §546(e) because the bank was not a beneficiary of the payment and was nothing more than a mere conduit.[26] In so holding, the Eleventh Circuit relied on the requirement in §550 that a trustee may only avoid a transfer made by a "transferee."[27]

In *Resorts,* the Third Circuit rejected the Eleventh Circuit's reasoning, holding that the Eleventh Circuit's approach did not comport with the language of §546(e).[28] The Third Circuit held in *Resorts* that a "beneficial interest"

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11 11 U.S.C. §564(e).

12 11 U.S.C. §741(8). The phrase "settlement payment" is also found at §101(51A), as it relates to forward contracts.

13 *See Kipperman v. Circle Trust FBO (In re Grafton Partners LP),* 321 B.R. 527, 538 (B.A.P. 9th Cir. 2005) (holding that "statutory scheme [of §546(e) was] designed to protect trades that comply with the securities laws...."); *Zahn v. Upcaipa Capital Fund,* 218 B.R. 656, 676 (D. R.I. 1998) (private stock sale has nothing to do with clearance and settlement system, §546(e) would appear to apply to private stock transactions on its face, such interpretation would be inconsistent with legislative intent); *In re Norstan Apparel Shops Inc. v. Lattman,* 367 B.R. 68, 75-76 (Bankr. E.D.N.Y. 2007) (same); *Official Comm. of Unsecured Creditors v. Asea Brown Boveri Inc. (In re Grand Eagle Cos. Inc.),* 288 B.R. 484, 495 (Bankr. N.D. Ohio 2003) (same); *Brant v. Hicks, Muse & Co. Inc. (In re Healthco Int'l Inc.),* 195 B.R. 971, 983 (Bankr. D. Mass. 1996) (same).

14 *See Zahn,* 218 B.R. at 675; *Healthco,* 195 B.R. at 983.

15 *Jewel,* 196 B.R. at 352 (citing H.Rep. No. 420, 97th Cong., 2d Sess. 1 (1982), reprinted in 1982 U.S.C.C.A.N. 583).

16 *See, e.g., Zahn,* 218 B.R. at 675-76.

17 *Grand Eagle,* 288 B.R. at 494 (citing *Zahn,* 218 B.R. at 656).

18 *QSI Holdings,* 2009 WL 1905237 at *4 (holding that §546(e) applies to private stock sales, as statute does not distinguish between private and public securities); *Brandt v. B.A. Capital Co. (In re Plassein Int'l Corp.),* 366 B.R. 318, 326 (Bankr. D. Del. 2007) (same); *Official Comm. of Unsecured Creditors v. Acres of Diamonds LP (In re The IT Group Inc.),* 359 B.R. 97, 101-02 (Bankr. D. Del. 2006) (same); *Loranger Mfg. Corp. v. PNC Bank (In re Loranger Mfg. Corp.),* 324 B.R. 575, 584 (Bankr. W.D. Pa. 2005).

19 *See, e.g., QSI Holdings Inc. v. Alford,* 382 B.R. 731, 743 (W.D. Mich. 2007), *aff'd,* 2009 WL 1905237 (6th Cir. July 6, 2009) (citing *Kaiser Steel Corp. v. Charles Schwab & Co. Inc.,* 913 F.2d 846, 849 (10th Cir. 1990) (relying on multiple securities law sources)).

20 *See, e.g., QSI Holdings,* 382 B.R. at 741.

21 *Contemporary Industries,* 564 F.3d at 985 (citing *Int'l Fin. Inc. v. Resorts Int'l, Inc. (In re Resorts Int'l, Inc.),* 181 F.3d 505, 515 (3d Cir. 1999) *(Resorts)*; *Jonas v. Resolution Trust Corp. (In re Comark),* 971 F.2d 322, 326 (9th Cir. 1992); *Kaiser Steel Corp. v. Charles Schwab & Co. Inc.,* 913 F.2d 846, 849 (10th Cir. 1990) *(Kaiser I)*.

22 2009 WL 1905237, at *4.

23 *In re Norstan Apparel Shops Inc.,* 367 B.R. 68 (Bankr. E.D.N.Y. 2007).

24 *Id.*

25 11 U.S.C. §546(e).

26 *Munford v. Valuation Research Corp. (In re Munford Inc.),* 98 F.3d 604, 610 (11th Cir. 1996) *(per curium) (Munford)*.

27 *Id.*

28 *Resorts,* 181 F.3d at 516.

requirement should not be read into the statute, because §546(e) "protects from the trustee's avoidance powers settlement payments made 'by...a financial institution.'"[29] The Eighth Circuit adopted this approach in *Contemporary Industries,* holding that §546(e) contains no requirement that the financial institution have a beneficial interest in a settlement payment.[30]

Having held that the LBO payments were exempt from avoidance under §546(e), the Eighth Circuit also agreed with the district court in that the same payments could not be avoided under state law theories of recovery, as "[a]llowing recovery on these claims would render the §546(e) exemption meaningless, and would wholly frustrate the purpose behind that section."[31] Relying on the Third and Eight Circuit decisions, the Sixth Circuit in *QSI Holdings* also held that a financial institution does not have to hold a beneficial interest in funds to implicate §546(e)'s exemption to avoidance.

Changing the Template for Structuring a Sale of Privately-held Stock

The Eighth Circuit's opinion in *Contemporary Industries,* as well as the Sixth Circuit's opinion in *QSI Holdings,* should lead bankruptcy and transactional lawyers alike to think about this possibility: By simply using a financial institution, instead of a law firm, to act as escrow agent for an LBO transaction involving the sale of privately-held stock, an otherwise fraudulent transfer of funds to the selling shareholders may be exempted from avoidance. This assumes that there is no actual intent to hinder, delay or defraud, and that any subsequent bankruptcy case filed by the company is in the "right" jurisdiction.

With *Contemporary Industries* and *QSI Holdings* in mind, perhaps this is obvious if the company being acquired is experiencing some kind of financial distress. Even if the target company appears to be on sound financial footing at the time of the transaction with no indication that bankruptcy may be in the company's future, it would seem prudent and wise for sellers' counsel to insist that the transaction be structured as a sale of stock and with the use of a financial institution as the escrow agent for disbursement of the funds to the sellers and the stock to the purchaser.

After all, if recent events have taught us anything, it is that the unexpected may well occur. In many situations, the purchaser and its counsel may be inclined to request that the purchase be structured as an asset sale out of concern that a stock purchase transaction might saddle the purchaser with unknown liabilities. Before conceding the point, perhaps the purchaser may be persuaded to structure the deal as a stock sale in exchange for protections in the contract against unknown liabilities. With the benefit of the §546(e) exemption in the event of a future bankruptcy, it may be worthwhile for the selling shareholders to agree on a purchase-price reduction in exchange for the purchaser's agreement to do a stock-purchase deal.

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When assessing the possibility that a payment for private stock will be exempt from avoidance under §546(e), it is important to consider that §546(e) does not protect payments within the scope of §548(a)(1)(A)—those made with actual intent to hinder, delay or defraud creditors.[32] It is noteworthy, however, that §548(a)(1) claims apply only to transfers made within two years before the date of the bankruptcy petition.[33] This leaves room to argue that even actual fraudulent-transfer claims brought under §544 and state law to recover transfers made more than two years prior to the petition date may be exempt from avoidance under §546(e).

That argument may be subject to being countered by maintaining that a transaction involving actual fraudulent intent is not the kind of payment that is "commonly used in the securities trade" as required by §741(8).[34] Accordingly, although the statute appears to permit an exemption from avoidance for transfers made with actual fraudulent intent if the transfers occur more than two years prior to the petition date, the language of §741(8) is broad enough to prevent wrongdoers from using §546(e) as a means to shield intentional and fraudulent conduct from avoidance as a fraudulent transfer.

Conclusion

From a policy point of view, the outcomes in *Contemporary Industries* and *QSI Holdings* may not make sense. After all, there is no policy reason why Congress would have wanted to permit a shareholder of an insolvent company to extract from the company funds for themselves while saddling the company with debt through an LBO that directly results in the company filing for bankruptcy relief and leaving creditors of the company unpaid.

These recent circuit court cases, under the plain-meaning rule for statutory interpretation, do not wrestle with this policy concern. It is now up to counsel to reevaluate how to structure transactions involving the sale of private stock to take full advantage of the possibility of increasing the protections available to the selling shareholders from future avoidance actions. ■

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29 *Id.*
30 *Contemporary Industries,* 564 F.3d at 986-87.
31 *Id.* at 988.
32 *See* 11 U.S.C. §546(e).
33 *See* 11 U.S.C. §548(a)(1).
34 *Kipperman v. Circle Trust FBO (In re Grafton Partners LP),* 321 B.R. 527, 539, 541 (9th Cir. B.A.P. 2005) (holding that transaction involving illegally registered securities was not "commonly used in the securities trade," and thus did not fall within definition of "settlement payment" under §741(8)).