

***IN RE RESORTS INTERNATIONAL, INC.: THIRD CIRCUIT EFFECTIVELY BARS
APPLICATION OF FRAUDULENT CONVEYANCE STATUTE TO PAYMENTS TO
PUBLIC SHAREHOLDERS IN LEVERAGED BUYOUTS***

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INTRODUCTION

On June 30, 1999, the United States Court of Appeals for the Third Circuit held that payments to shareholders in a leveraged buyout ("LBO") of a public company that passed through financial intermediaries were not recoverable as fraudulent conveyances.¹ The court based its decision on a "plain language" reading of 11 U.S.C. § 546(e) that protects "settlement payments" made "by or to . . . a financial institution" from a trustee's avoidance powers.²

The *In re Resorts Int'l, Inc.* decision will have important implications because many large Chapter 11 cases involving failed LBOs are filed within the Third Circuit, which includes Delaware. With this decision, the court substantially curtails the scope of the bankruptcy estate's avoidance powers in cases involving failed LBOs.

BACKGROUND

Fred Lowenschuss ("Lowenschuss") was the holder of 105,900 shares of Resorts International, Inc. ("Resorts") stock. In 1988, Griffco Acquisition Corporation ("Griffco") purchased Resorts in an LBO for a price of \$36 per share. After the merger was consummated, Resorts sent a formal notice of merger with Griffco to the shareholders, indicating they could either tender their shares and receive \$36 per share or obtain an appraisal under the Delaware Corporation Law. Lowenschuss sent Resorts a letter demanding an appraisal.

While those appraisal proceedings and related litigation were in process, Lowenschuss, through his broker, tendered his shares to Resorts' transfer agent for the merger. The transfer agent then sent a list to Resorts of the tendering shareholders accompanied by a request to have Resorts wire funds to the payment account. About two weeks subsequent to the tender, the transfer of funds was authorized by Resorts' treasurer. The transfer agent accordingly gave the broker a check for approximately \$3.8 million which was credited to Lowenschuss's account.

¹ *In re Resorts Int'l, Inc.*, 1999 U.S. App. LEXIS 14651 (3d Cir. Jun. 30, 1999).

² *Id.* at *25 (quoting 11 U.S.C. § 546(e)).

When Resorts realized that it had paid Lowenschuss the merger price for his shares of stock at the same time as he was litigating his appraisal rights, it brought an action to recover the payment. Subsequent to Resorts initiating a Chapter 11 reorganization, the case was removed from the Eastern District of Pennsylvania to the Bankruptcy Court for the District of New Jersey. There, Resorts sought restitution of the transferred shares based on a claim that the payment was (1) the result of a mistake by a Resorts employee, (2) a product of fraud, (3) contrary to Delaware corporate law, and (4) an avoidable transfer by a bankrupt entity.³ The Bankruptcy Court awarded Resorts full restitution on the alternative grounds of mistake and fraud, and appeared also to rely on the doctrine of illegal contracts and in pari delicto.

The District Court reversed the Bankruptcy Court's decision, citing that there was no mistake of fact and no reasonable reliance upon any misrepresentation. Resorts appealed the District Court's decision and also reasserted that the transaction was avoidable as a fraudulent conveyance.

ANALYSIS

After disposing of Resorts' assertions that it should have prevailed at trial on the three common law theories of fraud, mistake, and illegal contract, the court of appeals moved to the issue of fraudulent conveyance.⁴ Resorts asserted that its payment to Lowenschuss was avoidable as a fraudulent conveyance under 11 U.S.C. § 548(a)(1)(B).⁵

³ See *id.* at *6.

⁴ On the issue of fraud, the court held that "Resorts should have reviewed the list of tendering shareholders or contacted the court to determine whether it had custody of the shares." *Id.* at *12. Given that Resorts did neither, the court concluded that "there was simply no reliance, reasonable or otherwise, by Resorts" and the claim was therefore rejected. *Id.* On the issue of mistake of law, the court held that Resorts was "simply careless in entering into this contract by paying Lowenschuss for his shares when it may not have been obligated to," and thus there was an untenable claim arising from ignorance or mistake of law. *Id.* at *15. The court further concluded that due to Resorts' failure to exercise reasonable care its ignorance was self-imposed and thus no claim to mistake of fact was available. Finally, on the issue of illegal contract, the court felt that both Lowenschuss and Resorts were to blame for the resulting transaction and were in pari delicto. Thus the court rejected any recovery based on this doctrine.

⁵ Section 548(a)(1)(B) allows bankruptcy debtors to avoid some transactions completed before the bankruptcy filing. It states in part:

The trustee may avoid any transfer of an interest of the debtor in property . . . that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily . . . received less than a reasonably equivalent value in exchange for such transfer or obligation; and . . . was insolvent on the date that such transfer was made. . . .

11 U.S.C. § 548(a)(1)(B).

The fraudulent conveyance statutes are meant to protect unsecured creditors of a business from the dissipation of assets and other transactions which similarly disadvantage them. While the fraudulent transfer laws of different states vary from one another and from the federal Bankruptcy Code's provisions, generally these statutes permit a bankruptcy estate to invalidate transfers of property and indebtedness incurred prior to the bankruptcy if (1) the company received less than reasonably equivalent value in exchange for the property transferred or debt incurred and (2) at the time of the transfer of property or incurrence of debt, the company was insolvent, unable to pay its projected debts as they came due or had unreasonably small capital to carry on its business, or by virtue of the transfer of property or incurrence of debt, the company was placed in such financial condition. Numerous courts during the 1980's and 1990's have held that such laws can apply to LBOs which wind up in bankruptcy.⁶ Such courts have consistently reasoned that the company which is acquired does not receive equivalent value for the debt burden it undertakes because the money borrowed does not remain with the company, but is distributed to the company's shareholders. However, the courts have undertaken searching analyses in each case to determine whether the LBO placed the company in the financial condition specified by the fraudulent conveyance statutes, reaching different conclusions from case to case.⁷

Thus, a showing that Resorts received less than reasonably equivalent value for the approximately \$3,800,000 it paid for Lowenschuss's shares and that Resorts was insolvent on the date of the transfer, would give rise to the application of 11 U.S.C. § 548 and allow the trustee to avoid the transfer. In the present case, Resorts' claim that its LBO was fraudulent to its creditors was buttressed by the fact that the transaction took place less than a year before its bankruptcy filing.

After noting § 548 and its possible application, the court then discussed the relevance of § 546(e). Section 546(e) was inserted into the Bankruptcy Code in 1984, along with other amendments dealing with swaps and other financial instruments. By those amendments, Congress attempted to promote the stability of the commodity and securities markets. Section 546(e) immunizes a payment from avoidance if it is a "settlement payment."⁸ Therefore, the

⁶ See, e.g., *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986); *Wieboldt Stores, Inc. v. Schottenstein*, 131 B.R. 655 (N.D. Ill. 1991); *Crowthers McCall Pattern, Inc. v. Lewis*, 129 B.R. 992 (S.D.N.Y. 1991).

⁷ See, e.g., *Mellon Bank v. Metro Communications, Inc.*, 945 F.2d 635 (3d Cir. 1991).

⁸ The statute states in part:

Notwithstanding section[] . . . 548(a)(1)(B) . . . of this title, the trustee may not avoid a transfer that is a . . . 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

issue for the court was determining whether Resorts' payment was a "settlement payment" exempt from the application of § 548(a)(1)(B).

The term "settlement payment" is defined in both § 101 and § 741 of the Bankruptcy Code. The latter section, which falls in the subchapter applicable to "Stockbrokers Liquidations," is the pertinent section for payments which pass through a stockbroker, as Resorts' did. It defines a "settlement payment" to be "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"⁹

The court began its analysis by reviewing a number of cases where the meaning of "settlement payment" was addressed. In *Bevill, Bresler & Schulman Asset Management Corp. v. Spencer Savings & Loan Ass'n*, the Third Circuit had discussed the meaning of "settlement payment" under § 546(f) in a securities transfer under repurchase ("repo") agreements.¹⁰ The Resorts court concluded that *Bevill* had adopted an extremely broad definition of "settlement payment" which seemed to encompass the Resorts transaction. That decision did not consider payments made pursuant to an LBO and thus did not provide a definitive answer.

The court then looked to *Kaiser Steel Corp. v. Charles Schwab & Co.*, where the Tenth Circuit Court of Appeals stated that a settlement payment is generally the transfer of cash or securities made to complete a securities transaction.¹¹ Applying this definition, the *Resorts* court concluded that the transaction before it, which was composed of securities being passed from Lowenschuss's broker to the transfer agent, and funds then being wired from Resorts to the transfer agent, and forwarded to the broker, who paid Lowenschuss, constituted a "settlement payment."

The court also cited the Tenth Circuit's decision in *Kaiser Steel Corp. v. Pearl Brewing Co.* the first (and the only previous federal appellate) decision on this issue which held that payments to shareholders as part of an LBO were "settlement payments" under the statute.¹²

In examining the counter-argument that "settlement payments" do not include payments made for shares by a corporation as part of an LBO, the court cited a number of later district court cases which had criticized *Kaiser Steel*.¹³ Those courts reasoned that "the system of

⁹ 11 U.S.C. § 741(8).

¹⁰ 878 F.2d 742 (3rd Cir. 1989).

¹¹ *Kaiser Steel Corp. v. Charles Schwab & Co.*, 913 F.2d 846 (10th Cir. 1990).

¹² *Kaiser Steel Corp. v. Pearl Brewing Co.*, 952 F.2d 1230, 1239-40 (10th Cir. 1991).

¹³ See, e.g., *Zahn v. Yucaipa Capital Fund*, 218 B.R. 656 (D.R.I. 1998); *Weiboldt Stores, Inc. v. Schottenstein*, 131 B.R. 655 (N.D. Ill. 1991).

intermediaries and guarantees” present in the typical securities transaction is not present in an LBO.¹⁴

Siding with the *Kaiser Steel* decision, the Resorts court concluded that the term “settlement payments” encompasses almost all securities transactions. The court further stated that payments made during LBOs fell within the broad scope of this definition. Thus, “a payment for shares during an LBO is obviously a common securities transaction, and . . . a settlement payment for the purposes of § 546(e).”¹⁵

In rendering its decision, the court rejected Resorts’ argument that the transaction was not a “settlement payment” because the “bank never acquired a beneficial interest in either the funds or the shares.”¹⁶ The court instead relied on the “plain language” of the statute and did not read into § 546(e) the requirement that financial intermediaries obtain a beneficial interest in the funds they handle. The court felt that such a requirement was not explicit in the statutory language. The court further stated that although payments to shareholders in an LBO are not the most common securities transactions, no absurd result occurs by extending the definition of “settlement payments” to include such transactions.

SUMMARY

Resorts is significant because it is the second appellate court to exempt payments to public shareholders in an LBO from recovery in a subsequent fraudulent conveyance action. It reverses a trend, evident in *Zahn* and *Wieboldt Stores*, of lower courts disagreeing with the Tenth Circuit’s *Kaiser Steel* decision on this subject. Because many bankruptcy cases involving failed LBOs file in Delaware, which is within the Third Circuit, the decision should have significant precedential effect. Having two circuit courts of appeals in agreement should deter fraudulent transfer challenges of similar transactions in other circuits as well.

It should be noted that this decision arose out of an LBO of a publicly held company in which payments flowed to public shareholders through financial intermediaries customarily involved in the settlement of securities transactions. It is unclear, however, whether an LBO of a closely held corporation would receive similar treatment from the courts, specifically whether courts would regard the payments to shareholders in that context to be “settlement payments” “commonly used in the securities trade” as § 741(7) requires. Accordingly, persons involved in an LBO of a privately held company should not assume that inserting financial intermediaries into the exchange of shares for cash will necessarily give rise to § 546(e) protection.

¹⁴ *Zahn*, 218 B.R. at 676.

¹⁵ *In re Resorts International*, 1999 U.S. App. LEXIS 14651 at *26.

¹⁶ *Id.* at *28.

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If you have any questions or comments concerning the *In re Resorts International* decision, please do not hesitate to contact Mark Thompson (at 212-455-7355).

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