

SHAREHOLDER LBO: Safe Harbor For Cash Out?

On April 21, 2011, the U.S. Bankruptcy Court for the Southern District of New York issued a ruling in the MacMenamin's Grill, Ltd. case allowing a trustee to avoid a shareholder cash-out transaction.

Shareholders owning 31% of MacMenamin's Grill wanted out. On August 31, 2007, the Shareholders entered into a stock purchase agreement with MacMenamin's under which it would purchase the Shareholders' stock for \$1.15 million. MacMenamin's borrowed the amount of the sales price from TD Bank. Upon the closing of the stock sale transaction, TD Bank wired the \$1.15 million directly to the Shareholders' accounts. TD Bank also received a promissory note from MacMenamin's and a lien on substantially all of MacMenamin's assets to secure repayment of the debt.

MacMenamin's ultimately filed for protection under Chapter 11 of the Bankruptcy Code. The Trustee in bankruptcy then filed an adversary proceeding to avoid and recover payments made and liens granted. The Trustee relied on Section 548 of the Bankruptcy Code regarding "fraudulent conveyances". Section 548 is the avoidance provision that trustees have long relied on to undo leveraged buy-out transactions, or LBO's. "Fraudulent conveyance" is a partial misnomer, because fraud is NOT required to avoid a transaction under Section 548 of the bankruptcy Code, which provides:

The trustee may avoid any transfer ... of an interest of the debtor in property ... that was made ... within 2 years before the date of filing ... if the debtor ... received less than a reasonably equivalent value in exchange for such transfer

The MacMenamin's stock sale was a classic LBO, where MacMenamin's signed a note for \$1.15 million and pledged all of its assets to secure payments of the note, but MacMenamin's received nothing in return. Rather, all of the value was received by the selling Shareholders.

In what might have been viewed as a lay-up by the Trustee, the Shareholders and the bank argued that another provision of the Bankruptcy Code trumped Section 548. Specifically, they argued that Section 546(e) provided selling Shareholders a "safe harbor" for liability associated with their stock sale. (Continued on page 2)

Section 546(e) provides:

The trustee may not avoid a transfer that is a margin payment ... or a settlement payment ... made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant ... in connection with a ... contract, ... that is made before the commencement of the case.

All the parties agreed that the Shareholders and the bank were “financial institutions”, that the stock purchase agreement was a “securities contract” and that the payment was a “settlement payment”.

The issue presented by the MacMenamin's case was whether Section 546(e)'s safe harbor applies to private stock sales, rather than public stock transactions. Congress's stated intent in enacting Section 546(e) was to reduce risk in public financial markets and their related clearing systems that might arise from a trustee's avoidance of long-settled securities transactions. The outcome boiled down to whether the court should follow the “plain meaning” of Section 546(e) as written, or whether the court should look beyond the statute to glean the true intention of the statute. Judge Drain of the Southern District of New York followed the true intention of the statute, and ruled that privately selling shareholders would NOT be protected by the section 546(e) safe harbor, which was intended to apply to “public” securities transactions. As an aside, Judge Drain noted that even if the safe harbor did apply, it would only apply to “transfers” and not to obligations incurred, such as the Note obligation to TD Bank in this case.

The MacMenamin's ruling stands in contrast to Delaware's Elrod Holdings Corp. decision in 2008, which allowed the Section 546(e) safe harbor to protect a private stock sale. In a similar factual scenario, the Elrod Holdings court followed the “plain meaning” of Section 546(e) and validated the stock transfers and attendant secured notes.

It will be interesting to see whether other Bankruptcy Courts throughout the U.S. adopt the MacMenamin's or the Elrod Holdings approach in addressing private stock sales. Clearly, all parties involved in such transactions should not count on the protections of Section 546(e) in structuring such transactions. Another takeaway from the decisions in MacMenamin's and Elrod is forum shopping. Debtors and lenders who seek to insulate prior stock transactions will likely seek a “safe harbor” in Delaware bankruptcy courts. Debtors who become hostile to its prior transaction, or creditors who may benefit from the avoidance of private sale transactions, may seek bankruptcy filings in the Southern District of New York.

We hope you found this information helpful. If you have any questions regarding the foregoing, or any other matter, please feel free to contact us.

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