



**Litigation Issues Arising from
M&A Transactions**

**LITIGATING BANKRUPTCY AND FRAUDULENT CONVEYANCE
ISSUES IN M&A DEALS: ARE THE CONSEQUENCES REAL
OR IMAGINARY?**

Meryl Macklin
Sharon Weiss
Rosario Vizzie

Today's Discussion

- Review of Standard Bankruptcy Clauses in the Merger and Acquisition Context
- Common Misperceptions About Standard Bankruptcy Clauses' True Intended Effect and Enforceability
- Discussion of Actual and Constructive Fraudulent Conveyance Basics and Due Diligence Steps to Head Off These Potentially Dangerous Post-Closing Challenges

Why is this important?

- To ensure the parties are getting the benefit of the bargain.
- Understand and assess risk.

Review of Standard Bankruptcy Clauses in the Merger and Acquisition Context

Focus today on:

1. “Termination on Bankruptcy” Clauses / *Ipsa Facto* Clauses
2. Waivers of the Automatic Stay
3. Potential liability resulting from fraudulent transfers

Enforceability of “Termination on Bankruptcy” or *Ipsso Facto* Contract Clauses.

- What Are *Ipsso Facto* Clauses?
- Types of Contracts that Ordinarily Feature *Ipsso Facto* Clauses
- Enforceability of *Ipsso Facto* Clauses
- Why do Parties Insert *Ipsso Facto* Provisions into M&A Agreements?

Typical Language Used in Ipso Facto Clauses

- Each of the following events or conditions shall constitute an "Event of Default":
 - (a) the Company shall commence any case, proceeding, or other action (i) under any existing or future Requirement of Law relating to bankruptcy, insolvency, reorganization, or other relief of debtors, seeking to have an order for relief entered with respect to it, or seeking to adjudicate it as bankrupt or insolvent, or seeking reorganization, arrangement, adjustment, winding-up, liquidation, dissolution, composition, or other relief with respect to it or its debts, or (ii) seeking appointment of a receiver, trustee, custodian, conservator, or other similar official for it or for all or any substantial part of its assets, or the Company shall make a general assignment for the benefit of its creditors;
 - (b) there shall be commenced against the Company any case, proceeding, or other action of a nature referred to in clause (a) above which (i) results in the entry of an order for relief or any such adjudication or appointment or (ii) remains undismissed, undischarged, or unbonded for a period of [NUMBER] days; or
 - (c) the Company shall generally not, or shall be unable to, or shall admit in writing its inability to, pay its debts as they become due and payable.

Typical Language Used in Ipso Facto Clauses (cont'd)

Another typical ipso facto clause reads:

- This Agreement shall terminate, without notice, (i) upon the institution by or against either party of insolvency, receivership or bankruptcy proceedings or any other proceedings for the settlement of either party's debts, (ii) upon either party making an assignment for the benefit of creditors, or (iii) upon either party's dissolution or ceasing to do business.

Enforceability of *Ipsso Facto* Clauses

- Generally, courts do not enforce *ipso facto* provisions in a bankruptcy case.

The Relevant Bankruptcy Code Sections

- Property of the Estate (11 U.S.C. 541)
- Automatic Stay (11 U.S.C. 362)
- Executory Contracts (11 U.S.C. 365)
- Sale/Use/Lease of Estate Property (11 U.S.C. 363)

Why do Parties Insert *Ipsso Facto* Provisions into M&A Agreements?

- Generally enforceable outside of bankruptcy
- Habit
- Limited exceptions to the general rule
 1. if the debtor or trustee is not permitted by "applicable law" to assume or assign the executory contract – § 365(e)(2)
 2. contracts to extend credit / issue securities – § 365(e)(2)(B)
 3. Forward Contracts - § 556
- Other provisions that are not considered “Termination on Bankruptcy”

Enforceability of Waiver of Automatic Stay

- General Information about an Automatic Stay
- Waiving the Automatic Stay
- Types of Contracts Ordinarily Containing Waiver of Automatic Stay
- Enforceability of Waiver
- Prevailing Trends Regarding Waivers
- Tips for Lenders Considering Using an Automatic Stay Waiver

How Courts Approach Waiving the Automatic Stay

- Majority of courts treat the waiver as a factor in deciding whether “cause” exists to lift the stay
- Most courts used to reject the stay as unenforceable per se as against public policy
- Uphold the stay waiver on the basis of freedom of contract

Tips for Lenders Considering Using an Automatic Stay Waiver

- Clearly establish that consideration for the stay waiver was given.
- If there are other creditors with significant claims against the borrower, have these creditors specifically consent in writing to the stay waiver, or become party to the actual stay waiver document.
- Make sure that the borrower is represented and advised by experienced counsel.
- Be able to definitively show that the debtor has no equity in the property (the outstanding loan balance exceeds the value of the collateral securing the loan).

Fraudulent Transfers in the M & A Context

- View as a “successor liability” issue where the seller can be sued by a third party after a deal closes
- Most common in asset-based transactions where a creditor seeks to void the sale in order to enforce a debt owed by the seller
- Fundamentally, a SELLER issue
- How can the asset sale be voided by a creditor?

Fraudulent Transfers: The Nuts & Bolts of a Claim

- Actual Fraud : A creditor can void as “actual fraud” any transfer made or obligation incurred by a debtor if the debtor acted with “[w]ith actual intent to hinder, delay, or defraud any creditor of the debtor.” Cal. Civ. Code § 3439.04(a)(1). Eleven factors, or “badges of fraud,” are used to determine actual fraud. Examples of the “badges” include whether:
 - The transfer or obligation was made to an insider;
 - The transfer or obligation was disclosed or concealed;
 - The value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;
 - The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred.

Fraudulent Transfers: The Nuts & Bolts of a Claim

- Constructive Fraud. A creditor can void as “constructive fraud” any transfer made or obligation incurred by a debtor if the debtor made the transfer “[w]ithout receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor either: (A) [w]as engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction[, or] (B) [i]ntended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor’s ability to pay as they became due.” Cal. Civ. Code § 3439.04(a)(2).

Fraudulent Transfers: Hot-Button Legal Challenges

1. Voiding Transfers By Applying The “Badges of Fraud” and “Reasonably Equivalent Value.”
2. Voiding Transfers By Recharacterizing Debt as Equity.
3. Voiding Transfers Based on Debtor’s “Insolvency.”

Hot Button Challenge # 1: “Badges of Fraud” and “Reasonably Equivalent Value”

- “Badges of Fraud” Challenges.
 - Most courts strictly apply the statutory “badges” to determine if debtor intended to hinder, delay or defraud a creditor. See, e.g., *In re Tag Entm’t. Corp.*, 2016 WL 1239519, at *1 (Bankr. C.D. Cal. Mar. 29, 2016) (no intent shown where six “badges” weighed in debtor’s favor); *In re Empire Land, LLC*, 2016 WL 1391297, at *1 (Bankr. C.D. Cal. Apr. 4, 2016) (summary judgment denied where three badges of fraud weighed in creditor’s favor).
 - Some courts apply “equitable considerations” instead of the badges. See, e.g., *In re Martirosian*, 2017 WL 1041107, at *1 (Bankr. C.D. Cal. Mar. 14, 2017) (party may prevail *even when no badges of fraud weigh in its favor*, since the “badges” are “*not exclusive*” to determine debtor’s intent).
- “Reasonably Equivalent Value” Challenges.
 - “Value” assessed from creditor’s perspective of whether net effect of transaction depleted the bankruptcy estate, not as a dollar-for-dollar exchange.
 - More common in “constructive” instead of “actual” fraud cases.

Hot Button Challenge # 2 : “Recharacterization”

- When Triggered : Actual or Constructive? Courts have been unclear on whether re-characterization applies to actual or constructive fraud. Compare *In re Fitness Holdings Intern., Inc.*, 714 F.3d 1141, 1147 (9th Cir. 2013) (discussing recharacterization under constructive fraud), with *In re UC Lofts on 4th, LLC*, 2014 WL 1285415, at *23 (Bankr. S.D. Cal. Mar. 27, 2014) (analyzing recharacterization as a separate claim).
- When Debt Is Recharacterized : Trend Toward Factor-Approach. Many courts now use a “factor approach” (Delaware) while others look to equitable considerations in assessing a parties’ intent (California).
 - **1) Delaware’s “Factor” Approach.** *LMI*, 2017 WL 1508606 (adopting Sixth and Third Circuit’s eleven factor test to decide if notes should be recharacterized as equity).
 - **2) California’s “Intent” Approach.** *UC Lofts*, 2014 WL 1285415 at *23. (considering the debtors’ and defendants’ intent, the relationship between them, and whether the defendants engaged in inequitable conduct).

Hot Button Challenge # 3 : Debtor's Insolvency

- **When Triggered: The Elements.** Creditors can use the UFTA's constructive fraud section to void a debtor's transfer or obligation the debtor incurred by proving (1) there is a conveyance or creation of an obligation, (2) the debtor, at the time of the conveyance, was insolvent or the transfer rendered him insolvent, and (3) the conveyance was made without a fair consideration. *Estate of Heigho*, 186 Cal. App. 2d 360, 365–66 (1960).
- **Rebutting The “Insolvency Presumption.”** Although Cal. Civ. Code § 3439.02 contains an insolvency presumption, it does not state which accounting methodology applies to determine insolvency. The Ninth Circuit bankruptcy court, in *In re Village Concepts, Inc.*, 2015 WL 8030974, at *1 (B.A.P. 9th Cir. Dec. 4, 2015), recently held, “there are two alternative tests to establish a debtor's insolvency—the balance sheet test and the cash flow test.” *Id.* at *8.
- **Minority View: Cash Flow Test.** Two recent cases, *Village Concepts* and *UC Lofts*, analyzed insolvency under the cash flow test. Notably, *Village Concepts* limited the liabilities it considered in a solvency calculation to those that were “definite” and “material,” while *UC Lofts* limited the assets it considered to those that were “accessible.” *Village Concepts*, 2015 WL 8030974 at *10; *UC Lofts*, 2015 WL 8030974 at *16.
- **Majority View : Balance Sheet Test.** Most courts analyze insolvency and use concepts such as “fair valuation” and “contingent liabilities” when employing a “balance sheet” methodology to determine if a company was insolvent at the time of the transfer.

Key Tips and Takeaways for Fraudulent Transfers

- Identify all creditors, including contingent or potential creditors;
- Assess likelihood of a claim;
- Confirm proper notice procedures;
- Evaluate whether sufficient value in is being exchanged for the assets (e.g., hire an accountant to perform a pre-emptive valuation?);
- Evaluate selling company's solvency with documentation;
- Review facts in light of “badges of fraud”;
- Review terms of any financing documents in light of risk of “recharacterization.”

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