

Delaware Bankruptcy Court Allows Debtor's Suit Against Seller in LBO to Proceed

On March 17, 2010, Judge Kevin Gross of the United States Bankruptcy Court for the District of Delaware denied a motion to dismiss an adversary proceeding in the Mervyn's Chapter 11 cases (In re Mervyn's Holdings LLC, Case No. 08-11586, Adv. Proc. No. 08-51402) in which one of the debtors, Mervyn's LLC ("Mervyn's") acting through its Official Committee of Unsecured Creditors, asserted fraudulent conveyance and breach of fiduciary duty claims against Target Corporation ("Target") related to Target's sale of Mervyn's in a 2004 LBO. This decision is noteworthy because the Court, resisting a recent judicial trend protecting sellers in these transactions, held that the Section 546(e) safe harbor for "settlement payments" did not shelter a LBO seller from fraudulent conveyance claims in light of the Court's decision to collapse the various transactions into a single conveyance. The decision is also significant because, with respect to the breach of fiduciary duty claims, the Court held that (1) under California law (Mervyn's is a California LLC), Target -- as a member of the LLC -- owed a fiduciary duty to Mervyn's and its creditors and (2) Delaware's borrowing statute was inapplicable where the statute of limitations of the jurisdiction in which the action arose is longer than that of Delaware.

I. Mervyn's LLC v. Lubert-Adler Group, LLC, et al.

A. Background

Mervyn's, a nationwide retailer of fashion and home décor products, was a wholly-owned subsidiary of the Target Corporation. On July 29, 2004, after an auction, Target entered into an equity purchase agreement with a group of private equity firms to sell its interest in Mervyn's. The private equity group formed "Mervyn's Holdings LLC" to receive the equity interest of the Mervyn's and they formed "MDS Companies" to spin-off Mervyn's valuable real estate assets. The agreement called for Target to convey 100% of its ownership interest in Mervyn's to Mervyn's Holdings for \$1.175 billion. The agreement prohibited Target from selling or transferring any of Mervyn's real estate and required Target to convert Mervyn's from a California corporation into a California limited liability company.

The sale closed on September 2, 2004. Mervyn's Holdings and the equity group borrowed using Mervyn's real estate as collateral and incurred substantial obligations to fund the sale. Mervyn's received no residual interest in its real estate and all or substantially

all of the loan proceeds were paid to Target. Mervyn's Holdings leased the real estate back to Mervyn's at a substantially increased rate to both service the acquisition debt and to extract value over time.

Mervyn's filed for Chapter 11 four years later, on July 29, 2008. Shortly thereafter, the Official Committee of Unsecured Creditors, acting on behalf of Mervyn's, filed an adversary proceeding alleging that (1) the LBO was a fraudulent conveyance (both actual and constructive) and Target was liable as a transferee of proceeds from the fraudulent conveyance, and (2) Target, as an owner of Mervyn's, breached its fiduciary duty to Mervyn's and its creditors. Mervyn's claimed that Mervyn's Holdings' actions destroyed its value and led to its Chapter 11 filing.

B. Mervyn's Fraudulent Conveyance Action

In its motion to dismiss, Target argued that the 2004 sale did not fall within either the Uniform Fraudulent Transfer Act or Delaware's fraudulent conveyance statute because (1) Target sold its membership interest in Mervyn's, not Mervyn's property,¹ (2) Target was not a transferee or subsequent transferee of Mervyn's property, (3) Target was not a guarantor or an initial transferee for whose benefit the transfers were made, (4) the transaction did not render Mervyn's insolvent (Target claimed that the 2004 sale was merely a change in ownership and that Mervyn's Holdings represented to Target that it had adequate capital for the purchase price), and (5) the 2004 sale was not made to hinder, delay or defraud creditors.

Collapsing the LBO Transaction into a Single Conveyance

In deciding the motion to dismiss, the Bankruptcy Court collapsed the events integral to the 2004 sale (including the execution of the sale agreement, the stripping of the real estate assets, and the leases) into a single conveyance. The Bankruptcy Court followed Third Circuit authority holding that when a series of transactions were "part of one integrated transaction," courts may look "beyond the exchange of funds" and "collapse" the individual transactions of a leveraged buyout.² Under this case law, instead of focusing on one of several transactions to determine the validity of a claim, courts consider the overall financial consequences these transactions have on creditors.³

In concluding that it was appropriate to collapse the 2004 sale into a single conveyance, the Bankruptcy Court considered three factors: (1) whether all of the parties

¹ Because Mervyn's was a California LLC, Target claimed that it only possessed a membership interest and not a direct stake.

² *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1302 (3d Cir. 1986).

³ *See In re Hechinger Inv. Co.*, 327 B.R. 537, 546-47 (Bankr. D. Del. 2005).

involved had knowledge of the multiple transactions, (2) whether each transaction would have occurred on its own, and (3) whether each transaction was dependent or conditioned on other transactions.⁴ The Court (accepting all well-pled facts as true for purposes of the motion to dismiss) found that the overall consequences of the transaction to creditors was “devastating” and noted that Mervyn’s was left with as little as \$22 million in working capital and acquired additional debt totaling over \$800 million. Accordingly, after collapsing the LBO into a single transaction, the Bankruptcy Court found that the complaint stated facts sufficient to support a potential claim against Target as a transferee in the alleged fraudulent conveyance.⁵

The Applicability of the Bankruptcy Code’s “Settlement Payment” Safe Harbor

The Bankruptcy Court rejected Target’s argument that, even if the 2004 sale was a fraudulent transfer, Mervyn’s was barred from avoiding the transaction because the transaction falls within the safe harbor of Bankruptcy Code Section 546(e). Section 544(b) authorizes the trustee to “avoid any transfer of interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law.” 11 U.S.C. § 544(b). Section 546(e), however, provides that, notwithstanding Section 544, “the trustee may not avoid a transfer that is a . . . settlement payment, as defined by section 101 or 741 of [the Bankruptcy Code], made by or to a . . . financial institution.” 11 U.S.C. § 546(e).

“Settlement payment” is defined under Section 741(8) to include “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.” 11 U.S.C. § 741(8). As the Bankruptcy Court noted, the Third Circuit has held that this definition is “extremely broad” and encompasses almost all securities transactions. The Bankruptcy Court similarly cited Third Circuit precedent holding that a transfer is made by or to a financial institution when a LBO payment is made by wire transfer (because federal regulations require wire transfers to be performed by a bank, a wire transfer must be made through a financial institution).

Although the case law cited by the Bankruptcy Court suggests an expansive application of Section 546(e), and courts in other circuits have recently issued decisions applying the safe harbor to protect LBO transactions, the Court held that Section 546(e) did not apply because (1) as a general rule, Section 546(e) does not apply to “collapsed”

⁴ The Bankruptcy Court found that (1) the facts established the ability to show that Target had constructive knowledge of the transactions that were going to take place after the conveyance of its membership interest in Mervyn’s, (2) all of the transactions comprising the sale required execution of the sale agreement, and (3) the actions of the parties were each dependent upon the others.

⁵ The Bankruptcy Court further found that the complaint alleged facts sufficient to support Mervyn’s actual and constructive fraud claims under Fed. R. Civ. P. 8(a) and 9(b).

transactions, and (2) although “settlement payments” include non-publicly traded securities (such as the membership interest in Mervyn’s), Section 546(e) did not apply to the other transactions surrounding the 2004 sale because they did not fall within the Section 741 definition of “settlement payment.” According to the Court, Target’s characterization of the 2004 sale as involving only the transfer of membership interests in exchange for loan proceeds failed to account for the totality of the sale transaction (in particular, the alleged spin-off transfer of real estate assets from Mervyn’s for virtually no consideration). The Court stated that it “firmly believes that because of the multiple conveyances made surrounding the 2004 Sale, section 546(e) does not apply.”

C. Mervyn’s Breach of Fiduciary Duty Claims

Applying California law to the breach of fiduciary duty claims, the Bankruptcy Court found that (1) members of an LLC owe fiduciary duties to the entity and its other members and (2) members of an LLC owe fiduciary duties to creditors when the entity is insolvent. Although no California court has explicitly stated that a member of an LLC owes the company fiduciary duties, the Bankruptcy Court concluded that the California Supreme Court would be more likely to find that such duties are owed to the LLC if it were to decide the issue.⁶ In rejecting Target’s argument that it did not owe a fiduciary duty to creditors when the company is insolvent, the Bankruptcy Court cited California cases that “definitively recognize a member’s duty to a company’s creditors when the company is insolvent.” Accordingly, the Court held that Target, as a member of Mervyn’s, owed a fiduciary duty to both Mervyn’s and its creditors.

Applicability of Delaware’s Borrowing Statute

Finally, the Bankruptcy Court rejected Target’s argument that Delaware’s 3-year statute of limitations for breach of fiduciary duty actions barred Mervyn’s breach of fiduciary duty claim because the action was filed more than 3 years after the sale. Delaware’s choice of law rules require application of “the law of the state of incorporation to issues involving corporate internal affairs.” Because the breach of fiduciary duty claim involved internal affairs of Mervyn’s, the Bankruptcy Court held that California law, not Delaware law, applied to the claim. Unlike Delaware, California has a 4-year statute of limitations for breach of fiduciary duty claims that had not yet run when Mervyn’s commenced its adversary proceeding.

In so ruling, the Bankruptcy Court rejected Target’s argument that Delaware law should apply because Delaware’s borrowing statute provides that when a cause of action

⁶ The Bankruptcy Court cited *First Am. Real Estate Info. Serv., Inc. v. Consumer Benefit Serv., Inc.*, 2004 WL 5203206, at *6 (S.D. Cal. 2004) for the proposition that, although the California Code is silent, a court is likely to find that a member of a California LLC owes fiduciary duties to the entity and its other members.

arises outside of Delaware, the action cannot be brought in Delaware after the expiration of the shorter of either (1) the time limited by Delaware law or (2) the time limited by the law of the state or country where the cause of action arose. The Court found that the borrowing statute did not apply because the statute of limitations in Delaware was shorter (not longer) than the statute of limitations in California -- the jurisdiction in which the breach of fiduciary duty claim arose -- and there was no threat of forum shopping by the plaintiff.

II. Implications of the Decision

The Bankruptcy Court's decision is notable in that it diverges from the general trend of finding sellers in LBO transactions to be protected from fraudulent conveyance claims by the Bankruptcy Code's safe harbors. Notably, the Court based its conclusion on an examination of the entirety of the transaction, including a spin-off of certain real property assets, which may not be relevant or applicable in other circumstances (and also which may not lead to ultimate liability at trial if fair value can be shown).

Additionally, the decision provides guidance on the application of Delaware's borrowing statute. The decision suggests that plaintiffs may file actions that would be time-barred under Delaware law if the action arises under the laws of another applicable jurisdiction in which the statute of limitations has not yet run. Again, the Court based its decision in this context on the facts and circumstances before it.

Please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under Bankruptcy and Restructuring in the "Practices" section of our website (<http://www.clearygottlieb.com>) if you have any questions.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

NEW YORK

One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

WASHINGTON

2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

PARIS

12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

BRUSSELS

Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

LONDON

City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW

Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

FRANKFURT

Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE

Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME

Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN

Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG

Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING

Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax