The Banking Law Journal

Established 1889

An A.S. Pratt® PUBLICATION

JULY/AUGUST 2017

LexisNexis

The Banking Law Journal

VOLUME 134 NUMBER 7 July/August 2017

LexisNexis®

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ISBN: 978-0-7698-7878-2 (print)
ISBN: 978-0-7698-8020-4 (eBook)
ISSN: 0005-5506 (Print)
ISSN: 2381-3512 (Online)

Cite this publication as:

The Banking Law Journal (LexisNexis A.S. Pratt)

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An A.S. Pratt® Publication

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MATTHEW BENDER

(2017-Pub.4815)

Editor-in-Chief, Editor & Board of Editors

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POSTMASTER: Send address changes to THE BANKING LAW JOURNAL LexisNexis Matthew Bender, 230 Park Ave, 7th Floor, New York, NY 10169.

POSTMASTER: Send address changes to THE BANKING LAW JOURNAL, A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207.

Court Guts Lyondell Trustee's Bankruptcy-Related Claims

*Michael L. Cook**

This article discusses a recent U.S. Bankruptcy Court for the Southern District of New York decision dismissing a litigation trustee's multi-billion dollar bankruptcy-related claims arising out of a December 2007 merger.

The U.S. Bankruptcy Court for the Southern District of New York, after a lengthy trial, dismissed on April 21, 2017 a litigation trustee's multi-billion dollar bankruptcy-related claims arising out of a December 2007 merger, finding that:

- "The Trustee failed to establish" insolvency "on two key dates";
- "The Trustee . . . failed to establish that an actual fraudulent transfer occurred"; and
- "[T]he Trustee [could] not prove the essential element of 'fault'" to support his breach of fiduciary duty claims.[1]

The Trustee did prevail on one count, however, obtaining a $7.2 million judgment on his claim for a lender's breach of a financing contract.

Bankruptcy Judge Martin Glenn, in a 177-page opinion, found that the Chapter 11 debtor, formed by a large pre-bankruptcy merger, had been "buffeted by a series of unplanned and [largely] unforeseeable events in the year after the Merger, including a deadly crane collapse and two unusually destructive hurricanes at its Houston refinery, wildly fluctuating oil prices, and the effects of the Great Recession at the end of 2008."[2] This theme—unforeseeable economic disasters—dominated the court's analysis, in contrast to the Trustee's assertions of fraud and deceit.

RELEVANCE

Most relevant in *Lyondell* is the Trustee's attack on "distributions (approximately $12 billion) to [the debtor's] shareholders paid as the merger

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[1] *In re Lyondell Chem. Co.*, 2017 Bankr. LEXIS 1097, **6, 13, 14, 16, 17 (Bankr. S.D.N.Y. Apr. 21, 2017).

[2] *Id.*, at *6.

consideration."[3] The Trustee alleged that the debtor's Chief Executive Officer ("CEO"), S, had inflated the debtor's projections.[4] This asserted misconduct, which allegedly enabled the financing for the merger, was the "underlying factual predicate" for the Trustee's claim that the corporate debtor made the distributions to shareholders "with actual intent to hinder, delay, or defraud" creditors under Bankruptcy Code ("Code") § 548(a)(1)(A). According to Judge Glenn, "the Trustee relied on a novel theory, . . . attempting to prove a fraudulent intent on the part of pre-merger Lyondell's CEO, [S], and then impute [S's] intent horizontally to [the acquiring parties]."[5] Because the trustee "failed to prove actual fraudulent intent by [S], . . . no amount of mental gymnastics [could] substantiate a recovery on an intentional fraudulent transfer claim . . . against" the buyer's ultimate owner, "the person who himself lost billions on [the debtor's] failure."[6] Moreover, "the Trustee gave no legitimate reason why [S] would volunteer to captain a ship he had engineered to sink . . . . [Nor would] the financing banks invest . . . billions of dollars in the doomed company despite seeing an iceberg on the horizon."[7]

Earlier decisions in *Lyondell* by another bankruptcy judge (Gerber) and a district judge "dealt with the actual fraudulent transfer claims."[8] Reversing the bankruptcy judge's dismissal of the complaint, the district judge held, "based on the facts alleged [by the Trustee], . . . [S's] knowledge, as [CEO] and chairman of the board of directors, of the grossly inflated. . . projections, could be imputed to Lyondell."[9] Another district judge in a similar case, however, disagreed with this reasoning and dismissed an actual fraudulent transfer claim.[10] Although bound by the earlier district court holding, Judge Glenn found that, despite the allegations of the complaint, "the proof at trial failed to establish [S's] intent to hinder, delay, or defraud creditors," causing "the actual fraudulent transfer claims" to "fail."[11]

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[3] *Id.*, at 141.

[4] *Id.*

[5] *Id.*, at *14.

[6] *Id.*

[7] *Id.*, at *15–*16.

[8] *Id.*, at *141.

[9] *Id.*, at *142, quoting *In re Lyondell Chem. Co.*, 554 B.R. 635, 638 (S.D.N.Y. 2016) (Cote, J.).

[10] *In re Tribune Co. Fraudulent Conveyance Litig.* (S.D.N.Y. Jan. 6, 2017) (Sullivan, D.J.) (intent could not be imputed to board members).

[11] 2017 Bankr. LEXIS 1097, at *144.

FACTS

A, a New York-based Delaware corporation, and its affiliate, B, "a Netherlands-based petrochemical company,"[12] acquired the debtor in a merger that "closed on December 20, 2007."[13] "The merger financing totaled $20.3 billion," and left the debtor "with [about] $2.3 billion of liquidity at the Closing Date."[14] B's equity was worth "billions of dollars when the merger. . .was arranged."[15] "While [B] did not contribute cash toward the Merger, its equity value supported the equity of the combined companies."[16] The goal of the merger was to combine B "with an American refining company" such as the debtor to become "a global petrochemical and refining company."[17]

The merger also included "a leveraged finance component more emblematic of a leveraged buyout."[18] Unlike the typical buyout, however, B "borrowed funds from financing banks secured by assets of the combined company while contributing its own equity to the transaction . . . with the financing banks funding the acquisition . . . ."[19] Funds from the financing, "totaling $20.3 billion," were used to pay the debtor's shareholders ($11.256 billion), an affiliate of B and an investment bank for their pre-merger "Toehold" investments in the debtor's securities ($1.2 billion), the debtor's creditors ($7.178 billion), B's creditors ($447 million), closing costs and professional fees ($219 million) plus other identified uses ($14.1 million).[20]

As noted earlier, the debtor faced increasing unforeseeable liquidity problems during 2008. It obtained more financing from four banks and an affiliate of A. The banks had undertaken their own diligence prior to the 2007 merger and created internal projections for themselves in reliance on projections obtained from the debtor's management. Despite the additional financing, "a series of business setbacks" caused the debtor's "liquidity to dwindle as 2008 came to a close," forcing it to seek Chapter 11 relief on January 6, 2009.[21]

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[12] *Id.,* at *3.

[13] *Id.*, at *6.

[14] *Id.*

[15] *Id.*, at *27.

[16] *Id.*, at *27.

[17] *Id.*, at *3–*4.

[18] *Id.*, at *50–51.

[19] *Id.*, at *51.

[20] *Id.*, at 53.

[21] *Id.*, at 23.

ANALYSIS

Excerpts from the lengthy *Lyondell* opinion show how the court disposed of the Trustee's fraudulent transfer, preference, and breach of fiduciary duty claims. As the court stressed, the "results in this case are very fact-dependent," but, "at bottom are driven by the Trustee's failure to prove his claims (except for breach of contract)."[22]

Constructive Fraudulent Transfer

Because "the Trustee failed to prove that [the debtor was] insolvent on [the relevant] transfer dates, it is unnecessary to include an extensive discussion of the separate reasonably equivalent value requirement," for "[i]f the transferor was solvent, a constructive fraudulent transfer claim fails."[23] As to the adequacy of the debtor's capitalization, "unforeseen challenges ultimately faced by a debtor are pertinent . . . ."[24] "Additionally, made-for-litigation projections should be viewed skeptically . . . . Here, the Trustee's litigation projections were billions of dollars lower for the projection period than contemporaneous ones that [the Trustee's expert] conceded were reasonable when made."[25] The debtor's projections may have been inaccurate, but it was "the Great Recession and a number of other factors discussed elsewhere in this Opinion [that] rendered Lyondell's projections unattainable," enabling the court to find that the debtor was still adequately capitalized.[26]

Of significance to the court was "the fact that the financing banks committed billions to the future of [the debtor] after a diligent review of the transaction . . . . [T]he financing parties had droves of public and private information on which to develop their own reasoned investment decisions."[27]

Actual Intent—Fraudulent Transfer

As for the debtor's asserted actual fraudulent intent, "the Trustee fell far short of showing fraudulent intent during the preparation of the [debtor's] projections."[28] "As the district court made clear, the standard of intent for a fraudulent transfer claim is high, requiring that the actor actually desires to

[22] *Id.*, at *21.

[23] *Id.*, at *126.

[24] *Id.*, at *131.

[25] *Id.*, at *139.

[26] *Id.*, at *213.

[27] *Id.*, at *215.

[28] *Id.*, at *19.

cause a certain action or that he believes that consequences are 'substantially certain to result from it.' "[29] Although the district court here "only held that the Trustee adequately *pled* an intentional fraudulent transfer claim[,] the standard of pleading a claim is not equivalent to the high bar in *proving* a claim."[30] Not only had the Trustee "failed to establish that the [debtor's] projections were used to defraud Lyondell's creditors," but he also "did not prove that [S] told [the debtor's financial officer] what result he should reach or attempt to fraudulently influence the [projections] process."[31] Nor did the principal of the acquiring parties have the requisite intent: "he invested with a view to enhance the profitability of the newly created [merged entity], not to defraud Lyondell's creditors."[32]

The Trustee further failed to "establish the required intent by proving badges of fraud."[33] There was no "transfer of essential assets; there were no pending lawsuits related to the transaction; no party absconded; and the transfer was not for essentially all of the debtor's assets . . . . [T]his was not a heist being committed in the dead of night . . . . [T]he Toehold transactions were negotiated between two sophisticated parties as a result of arms' length dealing," and the Trustee "procured no evidence" of actual fraud.[34]

The court also rejected the Trustee's efforts to impute the purported fraudulent intent of S to B, one of the acquirors. "The Trustee's theory would . . . allow . . . bankruptcy trustees to impute the intent of company officer A to corporation B," but was unable to provide the court with "support for such authority."[35] According to the court, accepting the Trustee's legal theory "would upend conventional wisdom, making a corporation not only liable for the actions of its officers (which is uncontroversial), but mak[e] a corporation accountable to the officers of a wholly unrelated corporation."[36] "[T]he Trustee's theory of imputing the intent of an alleged fraudulent transferor toward a transferee (or in this case, a new entity) would be directly opposed to a long line of case law holding that the intent of the transferor, not the

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[29] *Id.*, at *222, quoting 554 B.R. at 648.

[30] *Id.* (emphasis in original text).

[31] *Id.*, at *223.

[32] *Id.*, at *225.

[33] *Id.*

[34] *Id.*, at *225–*226.

[35] *Id.*, at *229.

[36] *Id.*, at *229.

transferee, is the relevant inquiry here."[37] Finally, because "the Trustee failed to prove wrongdoing by [S], the intent required to sustain an actual fraudulent transfer claim is lacking . . . ."[38]

Preference

As noted earlier, the Trustee failed to prove an essential element of his preference claim—insolvency. Specifically, the court found "the expert testimony of [the Trustee's expert] unreliable" and because that testimony was the "only evidence" offered by the Trustee on the critical insolvency issue, the Trustee had failed to carry "his burden to prove that [pre-bankruptcy payments] were an avoidable preference."[39]

The court rejected the Trustee's reliance on the debtor's internal emails referring to "the possibility of bankruptcy."[40] According to the court, "these emails may show that [the debtor's] employees were considering bankruptcy as a future possibility, [but] none of this internal discussion shows that [the debtor] was actually balance-sheet insolvent" on the relevant dates."[41] "[T]he applicable test for a preference claim is not whether management at the company was considering a Chapter 11 filing. The test is balance-sheet insolvency."[42]

Breach of Contract

The court rejected the defendants' argument that the debtor's "impending Chapter 11 filing constituted a material adverse change, excusing [the lending affiliate of B] from performance under the" material adverse change ("MAC") clause in the parties' revolving credit agreement. Although the defendants argued that the debtor's "preparations for bankruptcy [were] analogous to a decline in revenues," the court refused to "infer a solvency requirement where none was drafted by the parties."[43] Indeed, reasoned the court, the revolving credit agreement contained no "ongoing solvency requirement for the good reason that it was largely unnecessary, given the security for the loan . . . . [In the context of this transaction, it was] even less likely that the parties intended the [credit agreement] to contain an ongoing solvency requirement, when the

[37] *Id.*, at *229.

[38] *Id.*, at *230.

[39] *Id.*, at *234.

[40] *Id.*, at *234.

[41] *Id.*, at *235.

[42] *Id.*

[43] *Id.*, at *236.

agreement it was based on had every reason *not* to contain such a requirement."[44] "The parties had the opportunity to include an ongoing solvency provision in the . . . Credit Agreement when it was drafted and executed in 2008, but they did not. The Defendants cannot now stretch the MAC clause to include it."[45] B's lending affiliate "breached its obligation . . . to fund the draw request in December 2008."[46] Because of this breach, the court awarded restitutionary damages to the Trustee of "$7.2 million—representing the value unjustly retained by [B's affiliated lender]."[47]

Breach of Fiduciary Duty

The court rejected the Trustee's breach of fiduciary claims against the acquiring parties and their controlling shareholder. In short, "the Trustee failed to prove that [the debtor's] Chapter 11 filing was the result of [the acquiring principal's] alleged misconduct rather than of the aftermath of the Great Recession of 2008."[48]

COMMENT

The magisterial opinion in *Lyondell* provides a cautionary tale for bankruptcy trustees. Alleging a viable bankruptcy-related claim in a complaint is far different from proving that claim at trial. It also behooves trustees to probe the credibility of their so-called "experts." No party should ever have its expert skewered by the court, as was done here.[49]

The *Lyondell* decision is practically unassailable. Although the Trustee will undoubtedly appeal, the court's fact-intensive analysis after trial should prevent any appellate court from second-guessing the decision.[50] The court's thorough legal analysis in *Lyondell* should also withstand attack.

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[44] *Id.*, at *237 (emphasis in original text).

[45] *Id.*, at 239.

[46] *Id.*, at *239.

[47] *Id.*, at *242.

[48] *Id.*, at *253.

[49] *See id*, at *101–*103 (Trustee's expert relied on third party analysis "with scant information about how the litigation model had been developed, without informing himself as to differences between what [the third party] was saying as a litigation expert and what it had said in 2007, and without independently testing [the third party's] work. . . . He did not closely analyze any of the valuations prepared by the Banks or . . . identify any errors in the Banks' valuations. . . . [His] opinions were not credible.").

[50] *See* Fed. R. Bankr. P. 7052, incorporating Fed. R. Civ. P.52(a)(6) ("Findings of fact, whether based on oral or other evidence, must not be set aside unless clearly erroneous, and the

The court later granted the Trustee's claim for prejudgment interest on the breach of contract claim at the "mandatory" statutory rate of nine percent on May 15, 2017, running from December 31, 2008, the date of the breach. It rejected the defendants' argument that the inclusion of prejudgment interest is discretionary, relying on N.Y. CPLR § 5001(o), which mandates the New York nine percent prejudgment interest rate, and upon *Spector v. Mermelstein*[51] and *Gray v. Proteus Sports & Racing Cars Ltd*.[52]

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reviewing court must give due regard to the trial court's opportunity to judge the witnesses' credibility").

[51] 485 F.2d 474, 482 (2d Cir. 1993).

[52] No. 13 Cv. 8717 (JGK) (S.D.N.Y. Dec. 23, 2014).