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Feature

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Reducing Litigation Risk Through Transaction Independence

Takeaways from Tribune's Two-Step LBO

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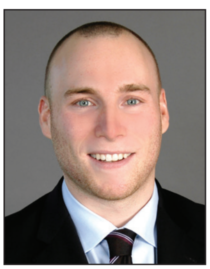

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The failure of a leveraged buyout (LBO) can result in complex, years-long litigation. Issues involving the debtor's solvency and the "collapse doctrine" are often at the heart of an LBO litigation. Under the collapse doctrine, "multilateral transactions may under appropriate circumstances be 'collapsed' and treated as phases of a single transaction for analysis."[1] The doctrine "finds its most frequent application to lenders who have financed [LBOs] of companies that subsequently become insolvent."[2]

A recent decision from the U.S. District Court for the Southern District of New York, dismissing claims for breach of fiduciary duty arising from Tribune Co.'s LBO in 2007, addresses these issues and provides useful guidance on structuring leveraged transactions and litigating LBO-related claims.

Tribune's Two-Step LBO

In 2007, Tribune, a publicly traded company, consummated a tender offer, then went private through a merger six months later. Prior to the LBO, Tribune's board of directors created a special committee to consider the LBO. The special committee included seven independent directors that served on the board. In the tender offer, referred to as "Step One," Tribune borrowed approximately $7 billion and paid $4.3 billion to its shareholders (approximately $34 per share) to repurchase approximately 50 percent of its outstanding stock on June 4, 2007.[3] Prior to closing Step One, Tribune obtained a solvency opinion that "vouched for Tribune's financial health after Step One."[4]

In the merger, referred to as "Step Two," Tribune borrowed an additional $3.7 billion and redeemed its remaining stock through a go-private merger that closed on Dec. 20, 2007.[5] Tribune's ability to consummate Step Two was contingent upon the satisfaction of various conditions, including Federal Communications Commission approval of the merger and a separate solvency opinion attesting that Tribune would be solvent after Step Two.[6] The board engaged Duff & Phelps LLC to provide a solvency opinion for both Steps One and Two. Duff & Phelps issued a "viability opinion" in which it found that, considering the potential tax savings, Tribune would be able to pay its debts after the LBO.

After intensive consideration of the "fairness" of the proposed transaction, the majority of the board, including six of the seven independent directors, voted in favor of the LBO. Ten days later, the board retained a valuation company to render a solvency opinion shortly before the completion of Steps One and Two.

Tribune's Bankruptcy and Ensuing Litigation

Shortly after the LBO was completed, Tribune began experiencing financial difficulties. On Dec. 8, 2008, one year after the merger, Tribune commenced a chapter 11 case.[7] Tribune's chapter 11 plan established a litigation trust in order to pursue various claims for the benefit of unsecured creditors. The trustee became the successor plaintiff in ongoing litigation that had been commenced previously by the committee of unsecured

1 *HBE Leasing Corp. v. Frank*, 48 F.3d 623, 635 (2d Cir. 1995).
2 *Id.*
3 *In re Tribune Co. Fraudulent Conveyance Litig.*, 2018 WL 6329139, at *2-3 (S.D.N.Y. Nov. 30, 2018) ("*Tribune I*"). The authors and their firm represented certain shareholders and directors in this litigation.
4 *Id.* at *3.
5 *Id.* at *2-3.
6 *Id.* at *3, *9.
7 *Id.* at *4.

creditors, suing thousands of parties that were involved in and/or received payments in the LBO.[8] Claims against former directors and officers (D&Os) included state law claims for breach of fiduciary duty, violations of the Delaware General Corporation Law, unjust enrichment, and (as to some but not all D&Os) aiding and abetting breach of fiduciary duty.

The trustee alleged in the complaint that Steps One and Two should be collapsed and deemed a single unitary transaction because, among other things, Tribune's board of directors approved both steps at the same time, the parties and public markets viewed the transactions as a "two-step transaction," and Step Two was "highly likely" to occur at the time of Step One.[9] Accordingly, the trustee argued that "in assessing Tribune's solvency at the time of Step One, the debt [that] Tribune had already agreed it would incur just a few months later to consummate Step Two" should also be considered.[10] In other words, the trustee argued that because Tribune was allegedly insolvent following the Step Two transaction, it must have also been insolvent following Step One because the steps comprised a single "unitary" transaction. The shareholder defendants filed a motion to dismiss the complaint.

Trustee Lacked Standing to Challenge Step One Unless Tribune Was Insolvent at Step One

First, the court began by analyzing whether a creditor can assert derivative claims against a corporation based on conduct that pre-dates the corporation's insolvency under Delaware law. The court found that a creditor's breach-of-fiduciary-duty claims are limited to conduct that "(a) occurred while the corporation was insolvent, or (2) directly and definitively caused the corporation to become insolvent." Thus, creditors cannot sue for D&O actions that simply made the company "less valuable"; the company must be insolvent.

Second, the court sought to determine whether the trustee — who represented the interests of Tribune's creditors — had standing to assert fiduciary claims against the shareholders and D&Os. In order to do that, the court had to determine *when* Tribune became insolvent.

Considering a motion to dismiss by three directors that had resigned immediately after Step One, the court analyzed the trustee's breach-of-fiduciary-duty and other state law claims against those directors solely with respect to Step One. The court began by recognizing that the trustee was pursuing claims for the benefit of Tribune's former creditors, and that

> creditors are limited under Delaware law to asserting breach-of-fiduciary-duty claims for conduct that either (1) occurred while the corporation was insolvent, or (2) directly and definitively caused the corporation to become insolvent. Creditors cannot sue for actions that simply made a solvent corporation "less valuable as an entity," even if that corporation eventually became insolvent.[11]

Thus, the court held that the trustee's standing depended on whether Tribune was solvent at Step One, which, in turn, depended on whether the Step Two debt should be considered (or collapsed) at Step One.[12]

Court Declines to Collapse Steps One and Two for Insolvency Analysis

The trustee urged the court to consider Steps One and Two to be a unitary transaction for the purpose of determining Tribune's insolvency. However, the court declined to follow the trustee's argument, finding that analyzing Steps One and Two under that concept would contradict Delaware law. The court applied a three-factor test that has been adopted in multiple jurisdictions (typically in the fraudulent-transfer context) to determine whether Steps One and Two should be collapsed for purposes of analyzing Tribune's solvency: (1) "Whether all of the parties 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."[13] The third factor in this test was the lynchpin in the court's analysis.

The court distinguished Tribune's "complex, two-step LBO transaction" (*i.e.*, a tender offer and merger more than six months apart) from the "paradigmatic" scenario involving collapse: where "one transferee gives fair value to the debtor in exchange for the debtor's property [*i.e.*, transfer one], and the debtor then gratuitously transfers the proceeds of the first exchange to a second transferee [*i.e.*, transfer two]."[14] In the "paradigmatic" scenario, courts invoke the collapse doctrine in order to recognize that the substance (or net effect) of the two transfers is that the debtor was left "holding the bag" because it gratuitously redirected the loan proceeds but was still liable for the debt.

In these circumstances, collapse is utilized to demonstrate that the debtor did not receive "a reasonably equivalent value" in exchange for the transfer, which is a necessary element of proving a constructive fraudulent transfer.[15] Thus, it makes sense to consider whether the initial transferor (who gave value to the debtor) knew and intended that the debtor would gratuitously redirect the proceeds.[16]

The court held that unlike the "paradigmatic" scenario, the instant case presented the question of whether to "collapse a *multilateral transaction* into a single transaction for purposes of assessing a corporation's *solvency*."[17] Within that

8 *Id.* at *1-2.
9 *Id.* at *9.
10 *Id.* at *8.

11 *Id.* at *7 (citing *Trenwick Am. Litig. Tr. v. Ernst & Young LLP*, 906 A.2d 168 (Del. Ch. 2006), *aff'd sub nom.*, *Trenwick Am. Litig. Tr. v. Billett*, 931 A.2d 438 (Del. 2007)); *see also N. Am. Catholic Educ. Programming Found. Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) ("[D]irectors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners" even in "zone of insolvency").
12 On reconsideration, the court clarified that regardless of the trustee's standing to bring Tribune's claims, the fiduciary duty claims were not viable based on an alleged harm to Tribune's creditors that resulted from the directors' actions at a time when Tribune was solvent. *See In re Tribune Co. Fraudulent Conveyance Litig.*, 2019 WL 549380, at *2 (S.D.N.Y. Feb. 12, 2019) ("*Tribune II*") (recognizing that trustee's standing to pursue Tribune's claims on behalf of creditors was irrelevant because "Tribune's fiduciaries were solely obligated to maximize shareholder value, without regard to Tribune's creditors").
13 *Tribune I* at *9 (quoting *In re Sabine Oil & Gas Corp.*, 547 B.R. 503, 541 (Bankr. S.D.N.Y. 2016), *aff'd*, 562 B.R. 211 (S.D.N.Y. 2016)); *see also Liquidation Tr. v. Fleet Retail Fin. Grp. (In re Hechinger Inv. Co. of Del.)*, 327 B.R. 537, 546-47 (D. Del. 2005); *Official Comm. of Unsecured Creditors v. CIT Grp./Bus. Credit Inc. (In re Jevic Holding Corp.)*, 2011 WL 4345204, at *5 (Bankr. D. Del. Sept. 15, 2011).
14 *Tribune I* at *9.
15 *See* 11 U.S.C. § 548(a)(1)(B)(i); *In re Sabine Oil & Gas Corp.*, 547 B.R. at 540 (recognizing that "the collapsing doctrine seems to be employed most often in the context of assessing reasonably equivalent value," but is not necessarily limited to that context).
16 *See HBE Leasing Corp.*, 48 F.3d at 635 (explaining "paradigmatic scheme").
17 *Tribune I* at *9 (emphasis added).

framework, the trustee's allegation that "the relevant parties clearly knew about both steps of the LBO, and, in fact, anticipated that both steps would be consummated" was not sufficient to collapse the transactions.[18]

Instead, the dispositive factor was that the trustee admitted in his complaint that "even after Step One closed, it was never *certain* that Step Two would occur," and in fact, "the parties specifically designed the two-step framework in light of [certain parties'] concerns that 'the deal would not actually close,'" and "the Trustee blames Tribune's directors for 'failing to act' in December ... 2007 when they ... could have prevented Step Two from closing."[19] The bankruptcy court in Tribune's chapter 11 case had made the same determination in connection with the confirmation of Tribune's chapter 11 plan (evaluating the plan's settlement of potential avoidance claims against the LBO lenders), concluding:

> I am not willing to dispense with the third factor in the particular collapsing question at issue here (*i.e.*, for purposes of determining solvency rather than reasonably equivalent value). Timing is key to this solvency issue. The debtor's assets and liabilities on a balance sheet are measured as of a particular date and, if the Step One transactions could stand on their own as of the closing of Step One, then it is not appropriate to collapse the steps for determining solvency at that time.[20]

Therefore, the district court concluded that Steps One and Two should not be collapsed because they were "independent transactions," and thus the court must "analyze ... the Trustee's insolvency allegations at each step of the LBO."[21]

Court Dismisses Step One Claims for Failure to Allege Insolvency

The court considered the trustee's allegations of insolvency at Step One according to the two tests for insolvency under Delaware law: (1) whether Tribune had "liabilities in excess of a reasonable market value of assets held"; or (2) "was unable to pay its debts as they fall due in the usual course of business."[22] With respect to the first test, sometimes referred to as "balance sheet solvency," the court held that the trustee's complaint "fail[ed] to support a finding that Tribune's liabilities exceeded its assets as of the close of Step One" without adding the Step Two debt.[23]

Next, the court rejected the trustee's argument that the "inability to pay debts when due" test is "forward-looking" and requires consideration of contemplated future transactions, reasoning that "the Second Circuit explicitly rejected [such] an insolvency test ... as inapplicable under Delaware law" because "the Delaware test looks solely at *whether the corporation has been paying bills on a timely basis* and/or whether its liabilities exceed its assets."[24] The court concluded that the trustee had failed to allege that Tribune had failed to pay any debt at the time of Step One or at any time prior to Step Two.[25]

The court rejected the trustee's argument that it should consider a third test, the "'unreasonably small capital' test, which posits that a company is insolvent when it is left with unreasonably small capital for the ongoing function of its business."[26] The court reasoned that although the Bankruptcy Code expressly includes that test, Delaware law governing the state law claims does not.[27] Thus, the court dismissed the state law claims against the three directors because the trustee failed to plausibly allege that Tribune was insolvent at Step One or that Step One rendered Tribune insolvent, which, in turn, meant that the trustee lacked standing to assert these claims.[28]

Takeaways

The *Tribune* decision is potentially instructive regarding highly leveraged transactions such as LBOs. The decision is notable in that it reinforces the Delaware courts' rejection of the "zone of insolvency" and cautions practitioners to organize highly leveraged transactions with a great deal of thought about potential insolvencies. Since Tribune's LBO was bifurcated into two steps with incremental debt incurred at each step, and with meaningful conditions and safeguards (*e.g.*, solvency opinion and other "outs") designed to ensure that each step would only occur if Tribune was fit to proceed, the transactions might have compartmentalized risk at each step. Although the Tribune transactions were bifurcated out of necessity,[29] the court might have reached the same conclusion had they been bifurcated by design.

Therefore, practitioners might consider breaking a highly leveraged transaction down into disparate transactions with safeguards at each stage. If the transactions are later challenged but a court determines that they are independent transactions (and should not be collapsed), the transaction structure could potentially reduce and compartmentalize risk. If the initial transaction is deemed to have been proper then, even if the latter transaction is deemed improper, this strategy might eliminate liability for defendants that only participated in the initial transaction, and reduce overall liability for defendants that participated in both. abi

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18 *Id.*
19 *Id.*
20 *In re Tribune Co.*, 464 B.R. 126, 166-67 (Bankr. D. Del. 2011).
21 *Tribune I* at *9.
22 *Id.* at *8, *10 (quoting *Pereira v. Farace*, 413 F.3d 330, 343 (2d Cir. 2005)).
23 *Id.* at *10.
24 *Id.* (quoting *Pereira* at 343) (emphasis in original; quotations omitted).
25 *Id.* at *10.
26 *Id.* at *8.
27 *Id.*
28 *Id.* The decision was issued by Hon. Richard Sullivan, who was subsequently elevated to the U.S. Circuit Court for the Second Circuit. The *Tribune* litigation was thereafter transferred to Hon. Denise Cote, who denied the trustee's motion for reconsideration of the decision. *See Tribune II* at *4.
29 Due to the need for Federal Communications Commission approval and other preconditions, Step Two could not have occurred at Step One.