IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	)	Chapter 11
	)	
PHYSIOTHERAPY HOLDINGS, INC., *et al.*	)	
	)	Case No. 13-12965(KG)
Debtors.	)	
	)	
	)	
PAH LITIGATION TRUST,	)	
	)	Adv. Pro. No. 15-51238(KG)
Plaintiff,	)	
	)	
v.	)	
	)	
WATER STREET HEALTHCARE PARTNERS L.P., *et al.*	)	
	)	
	)	
Defendants.	)	**Re: D.I. 106**
	)	

OPINION

Since its seminal decision in *United States v. Tabor Court Realty Corp.*, the Third Circuit has recognized that leveraged transactions may be subject to avoidance under state and federal fraudulent transfer law. 803 F.3d 1288 (3d Cir. 1986). Such transactions typically involve the target company incurring a substantial amount of debt, and the expected return on new equity is magnified significantly. However, when the target's financial conditions deteriorate due to firm-specific or systemic reasons, there is a corresponding increase in potential equity losses and the likelihood of insolvency. Such a leveraged deal structure may constitute a fraudulent transfer if the target received, *inter alia*, "less than a reasonably equivalent value in exchange for such transfer or obligation" and "became insolvent as a result of such transfer or obligation." *See, e.g.*, 11 U.S.C. § 548(a)(1)(B).

Here, the PAH Litigation Trust[1] (the "Trust" or "Trustee") asserts eight counts of fraudulent transfer claims (the "Complaint") against numerous defendants including Water Street Healthcare Partners, L.P. ("Water Street") and Wind Point Partners IV, L.P. ("Wind Point") (collectively, the "Defendants" or the "Controlling Shareholders"). Claims were also filed against certain subsequent transferees (the "Subsequent Transferees"). More specifically, the Trustee seeks to recover $248.6 million in payments made to the Controlling Shareholders and other selling shareholders (the "Selling Shareholders") in exchange for their equity in Physiotherapy Holdings, Inc. ("Physiotherapy" or the "Debtor"). The Trustee alleges that in order to finance the sale of Physiotherapy, the buyer's ("Court Square" or the "Purchaser") merger subsidiary issued $210 million in senior secured notes (the "Secured Notes"). Pursuant to the terms of the transaction, the Debtors assumed the Secured Notes and certain other liabilities. Physiotherapy issued the Secured Notes pursuant to an offering memorandum (the "OM") which the Trustee alleges fraudulently overstated the Debtor's revenue stream and its overall firm value. According to the Complaint, the Purchaser ultimately acquired an insolvent company, and the Secured Noteholders received debt instruments worth far less than their face value. The Trustee alleges that this sequence of events led to the Debtor's chapter 11 petition and seeks to claw back certain payments made to the Selling Shareholders under both state and federal fraudulent transfer law.

In response to the Complaint, the Defendants seek dismissal under Rule 12(b)(6) of the Federal Rules of Civil Procedure. The Defendants' argument that the Trustee has failed to state a claim is based upon four grounds: (1) the transaction is protected by the safe harbor of section 546(e) of the United States Bankruptcy Code (the "Code"); (2) the claims are barred as a result of a post-transaction release entered into by the Selling Shareholders and the Purchaser; (3) the

[1] The Trust is a creation of Physiotherapy's Plan of Reorganization. D.I. 18.

Secured Noteholders ratified the transaction and are thus barred from seeking its avoidance, and; (4) with respect to the actual fraudulent transfer claims, the Trustee has failed to meet the heightened pleading standard under the Federal Rules of Civil Procedure. For the following reasons, the Motion is hereby granted in part and denied in part.

FACTS[2]

The Debtor is a leading provider of outpatient physical therapy services throughout the United States. Compl. ¶ 3. Defendants Water Street and Wind Point are private equity funds whose portfolio companies consist of businesses in the healthcare sector. Compl. ¶ 2. As of 2012, the Debtor operated approximately 650 clinics in 33 different states and derived the majority of its revenue from outpatient rehabilitation services. Def.'s Br. 14. In 2007, Defendant Water Street acquired Physiotherapy for roughly $150 million. *Id*. Shortly after the transaction closed, Water Street entered into an agreement (the "2007 Merger") to merge the Debtor with Benchmark Medical, Inc. ("Benchmark"), an "outpatient physical therapy chain that Wind Point had previously acquired." *Id*. Following the 2007 Merger, Water Street owned 45% of the common stock of the surviving entity while Wind Point held a 35% ownership stake. *Id*. Throughout the next five years, the Controlling Shareholders gradually increased their ownership to approximately 90% of the Debtor's common shares. Compl. ¶¶ 14, 16. The Trustee alleges that during this time, Water Street and Wind Point engaged in various forms of accounting fraud in order to overstate Physiotherapy's financial health and reap a substantial profit from the sale of their shares. *Id*. As a result of these alleged misrepresentations, the Controlling Shareholders "received the $248.6 million transfer from the [D]ebtor without providing anything of similar value and return . . . and benefitted handsomely from the fraud." Compl. ¶ 1.

[2] The well-pleaded facts in the Complaint are accepted as true for the decision on the Motion. *See Ashcroft v. Iqbal*, 556 U.S. 662, 664-65 (2009).

The alleged fraud began as a result of the 2007 Merger as the Debtor was faced with numerous operational challenges arising from the Controlling Shareholders' efforts to integrate the accounting systems of Benchmark and Physiotherapy. Compl. ¶ 3. According to the Trustee, "[t]here were delays in implementing a new single accounting system to replace the various legacy systems; there were problems keeping up with cash collections; and there were almost no internal financial reporting controls." *Id*. The Complaint further alleges that the Debtor began to overstate its EBITDA, net revenue, and accounts receivable in 2010 in order to conceal these problems. Compl. ¶ 4.

Before discussing how the Debtor allegedly manipulated its financial statements, some background about the various forms of revenue recognition methods is necessary. In the healthcare industry, providers typically do not receive payment for services directly from patients. Compl. ¶ 30. Rather, providers are paid from third parties including "healthcare insurers, managed care organizations, and Medicare and Medicaid." *Id*. Typically, there is some delay between the time the service is rendered and the time payment is received. *Id.* Consistent with the principles of accrual accounting, revenue is generally recorded at the time it is earned, and Physiotherapy historically recognized revenue on this former date. Compl. ¶ 31. In general, gross revenue is recorded at the provider's published rates. Compl. ¶ 32. However, because providers typically negotiate individual agreements with third-party payors such as insurance companies, rates may vary from contract to contract. *Id*. With respect to each third-party payor, there generally is a discount from the published rate. *Id*. Accordingly, GAAP requires a provider to "make reasonable estimates of these 'contract adjustments' – the difference between the published rates and expected third-party payor payments based on the negotiated contract rates and discounts." Compl. ¶ 33. The healthcare provider then deducts these adjustments from gross revenue in order to arrive at net revenue. *Id*. Because net revenue is a primary driver of any company's earnings, variations in these estimates can have a profound impact on a healthcare provider's EBITDA. *Id*. Consequently, accuracy is crucial in order to provide an accurate picture of the company's financial health. In light of this concern, healthcare companies generally utilize the "look back method" of adjustment. Compl. ¶ 34. The look back method requires financial statement preparers to make the relevant contractual adjustment by examining "actual historical collections for claims that have already been closed and paid during the last 90 to 180 days." *Id*.

By 2009, Physiotherapy's financial condition had deteriorated significantly. Compl. ¶ 36. In response, the Controlling Shareholders allegedly began to implement new strategies in order to sell the Company by 2011 or 2012 and maximize the potential sales consideration. Compl. ¶ 37. One particular strategy was to abandon the "look back method" of revenue recognition and adopt the more controversial "rate bridge method." Compl. ¶ 39. Physiotherapy's board was, according to the Trustee, aware of and sanctioned the use of the rate bridge method. Compl. ¶ 43. According to the Complaint, the rate bridge method estimates revenue by calculating "a 'net rate per visit' based on the prior month's net rate per visit – which was, at the time, based on an estimate – and adjusted upward or downward based on supposed increases and/or decreases to the published rates and assumptions about the amount Physiotherapy could charge per visit or per 'unit.'" Compl. ¶ 40. Unlike the look back method, the rate bridge method is not based on actual historical collections and may be subject to manipulation. Compl. ¶¶ 41-42. Indeed, within six months of switching to the rate bridge method, the Debtor's management became aware that the Company's net revenue had been overstated. Compl. ¶ 44. Nonetheless, it continued to apply this revenue recognition methodology in order to maximize a potential sales price.

The marketing process formally began in October 2011 when the Controlling Shareholders solicited bids from more than 100 potential buyers. Compl. ¶ 45. Twenty-three companies submitted preliminary bids, and there were three bidders remaining in January 2012. *Id*. As participants dropped out of the auction process, Water Street and Wind Point allegedly pressured the Debtor's senior management into "manipulat[ing] the Company's net revenue and patient visit counts so that Physiotherapy could be marketed as a company that was able to grow its net revenue per visit year over year." Compl. ¶ 47. The Complaint specifically details six forms of alleged accounting fraud that enabled the Defendants' to inflate Physiotherapy's earnings. Compl. ¶¶ 48-54.

- The Debtor allegedly characterized certain visits as "commercial (non-contract)" even though there was an associated contract. Compl. ¶ 48. This enabled the Debtor to overstate its revenue by omitting the discount associated with the actual contract. *Id*.

- The rates attributed to the commercial class of visits were substantially higher than the cash that was actually collected. Compl. ¶ 49.

- Physiotherapy "inflated the overall net rate per visit." Compl. ¶ 50.

- Physiotherapy allegedly double booked revenue related to "the 'contract revenue' payor class." Compl. ¶ 51.

- The Debtors allegedly inflated the number of patient visits per month, which had the obvious effect of increasing gross revenue. Compl. ¶ 52. An internal e-mail produced by the Trustee indicates that the Debtor was "over-accruing visits by about 2,500 a month." *Id*.

- The Debtors directed IKS (the billing and collections vendor) to "falsify accounts receivable reports to force the "accounts receivable' data to match up with the company's general ledger." Compl. ¶ 54.

The Trustee also quotes numerous emails from the Debtor's billing and collections vendor indicating that the Debtor was instructing them to falsify its financial statements. Compl. ¶ 55. During this time, the Debtor began to develop substantial cash shortfalls as a result of these procedures. Compl. ¶¶ 61-70. The Complaint alleges that this growing discrepancy between revenue and cash collections was a result of Physiotherapy's switch to the rate bridge method. Compl. ¶ 72.

According to the Trustee, the Board of Directors was aware that the Debtor's use of the rate bridge method had led to inflated revenue. Compl. ¶¶ 59-61. Additionally, the Board was presented with tangible evidence that Physiotherapy was experiencing significant cash collection shortfalls. Compl. ¶¶ 61-63. In August 2010, the Board became aware that the shortfall had grown to approximately $23.5 million. Compl. ¶¶ 62, 65. Despite expressing its desire to recover this deficit, Physiotherapy consistently missed its cash collections targets throughout the next year. Compl. ¶¶ 66-67. Additionally, uncollected receivables continued to grow substantially. Compl. ¶ 69. On February 1, 2012, the Debtor's CFO e-mailed board members (the "Board") informing them that the rate bridge method was responsible for this trend. Compl. ¶ 72. In light of these growing disparities between cash collections and revenue, the Trustee alleges that the Board was aware that "the revenue recognition methodology used by Physiotherapy was grossly overstating its net revenue." Compl. ¶ 73.

The Trustee further alleges that various third parties presented the Board with tangible evidence that Physiotherapy had been overstating its revenue. Compl. ¶ 74. In connection with an audit performed on behalf of a potential bidder, Pricewaterhouse Coopers LLP ("PwC") and Deloitte & Touche LLO ("Deloitte") analyzed the Debtor's financials and determined that Physiotherapy had been overstating both its net revenue and its net accounts receivable. Compl. ¶ 74. Specifically, they determined that accounts receivable had been inflated by approximately $17,524,000, or 25%. Compl. ¶ 75. Net revenue for 2011 was allegedly overstated by $24,167,000, or 10%. Compl. ¶ 76. The Board and management allegedly received a copy of the reports shortly before they approved the sale. *Id*. Because Water Street and Wind Point's representatives sat on the Board, the Complaint asserts that the Controlling Shareholders were well aware of these accounting manipulations. Compl. ¶¶ 77-80. Additionally, Water Street held various "investment committee meetings" pertaining to the anticipated sale of Physiotherapy, and notes of those meetings reveal that "Water Street and its Board appointees knew that the 'accounting noise in [the Debtor's] quality of earnings is high.'" Compl. ¶ 78.

Throughout this time, the Debtor had been engaged in an extensive marketing process. Court Square, a private equity firm, emerged as the winning bidder with a cash offer of $510 million. Def.'s Br. 20. The deal was structured as a reverse-triangular merger, and Court Square created a subsidiary to merge into Physiotherapy with Physiotherapy as the surviving entity. The subsidiary financed the transaction by issuing: "(i) a $100 million term loan (the "Term Loan"), which was part of a larger credit facility; (ii) $210 million in Secured Notes underwritten by Jefferies and RBC (the "Secured Notes"); (iii) a management equity rollover; and (iv) a minority investment by a third-party." Def.'s Br. 23. According to the Trustee, these Secured Notes were marketed with an OM that falsely represented Physiotherapy's pre-tax net income and unadjusted EBITDA. Compl. ¶ 82. The Trustee asserts that the OM overstated pre-tax net income by at least 936% and unadjusted EBITDA by 109% for fiscal year 2011. Compl. ¶¶ 83-84. Under the terms of the deal, the new Physiotherapy assumed this debt, and Water Street and Wind Point received $248.6 million in exchange for their shares. Compl. ¶ 88. Allegedly, the Controlling Shareholders profited handsomely from the fraud while the Company was left insolvent. Compl. ¶ 89. "The sum of all of the foregoing was that Physiotherapy incurred a massive amount of new debt—predicated on false financials—the proceeds of which were transferred out to Physiotherapy's former owners without receiving anything of value in return." *Id*.

The Trustee alleges that the Controlling Shareholders knew their shares were grossly overvalued and that the financial deterioration of the new company was inevitable once its new management uncovered the fraud. Compl. ¶ 98. Indeed from April 2012 to March 2013, pre-tax income and adjusted EBITDA deteriorated significantly. Compl. ¶¶ 101-02. Shortly after the transaction closed, the Company's new owner retained Deloitte to investigate a gap in accounts receivable and cash collections from the previous years. Deloitte determined that the Debtor's net income had been overstated for the years 2010 and 2012. On April 2, 2013, the Company defaulted on the Senior Notes, and on November 12, 2013 (the "Petition Date"), it filed for relief under chapter 11 of the Code. Compl. ¶¶ 104-09.

THE COMPLAINT

The Trustee filed an eight count Complaint seeking to avoid the payments made to the Selling Shareholders. Because the Senior Noteholders assigned their individual claims to the Trustee, the Litigation Trust has standing to assert claims in the capacity of both an estate representative and an assignee. Accordingly, Count I of the Complaint seeks avoidance and recovery of transfer of stock distributions under section 548(a)(1)(A) of the Code, the Bankruptcy Code's intentional fraudulent transfer provision. Count II similarly asserts a constructive fraudulent transfer claim under section 548(a)(1)(B). Count III seeks to avoid distributions made to the Subsequent Transferees under section 548(a)(1). Count IV is asserted under the "strong-arm" provision of Code section 544 and asserts that the Defendants violated section 5104(a)(1) of Pennsylvania's Fraudulent Transfer Act (the "Pa.C.S.A."). Count V is also brought under section 544 and the Pa.C.S.A and seeks to avoid the payments as constructive fraudulent transfers, while Count VI seeks to avoid payments made to the Subsequent Transferees under such state law. Count VII is asserted in the capacity of the Senior Noteholders and seeks to avoid the payments as constructive fraudulent transfers under the Pa.C.S.A while Count VIII seeks to recover certain distributions made to Subsequent Transferees.

STANDARD OF REVIEW

In order to survive a motion to dismiss, a plaintiff must go beyond "labels and conclusions." *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 555 (2007). A complaint must contain sufficient facts "to state a claim to relief that is plausible on its face." *Id*. at 570. Also, courts must accept all well-pleaded factual allegations as true but are not required to accept as true legal conclusions or conclusory statements. *Ashcroft v. Iqbal*, 556 U.S. 662, 664-65 (2009); *see also Santiago v. Warminster Twp.*, 629 F.3d 121, 130 (3d Cir. 2010).

Rule 8(a) of the Federal Rules of Civil Procedure requires that a complaint contain "a short and plain statement of the claim showing that the pleader is entitled to relief." FED. R. CIV. P. 8(a). Under this standard, substantive sufficiency and sufficient notice are all that are required under the Rules. *Id*. However, when a plaintiff's allegations involve claims of fraud, he must meet the heightened pleading threshold set forth in Rule 9(b). FED. R. CIV. P. 9(b). A fraud complaint must "plead with particularity the circumstances of the alleged fraud" by describing the "precise misconduct with which [the defendant] is charged." *Lum v. Bank of Am.*, 361 F.3d 217, 223-24 (3d Cir. 2004). With respect to the Trustee's intentional fraudulent transfer claims, the Court will discuss the applicable standard of review in that section of this Opinion.

DISCUSSION

I. Section 546(e) Safe Harbor

The Defendants first argue that the payments made to the Selling Shareholders are immune from avoidance as constructive fraudulent transfers under section 546(e) of the Code. Section 546(e) states:

> Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, ***the trustee may not avoid*** a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or ***settlement payment***, as defined in section 101 or 741 of this title, ***made by or to*** (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, ***financial institution***, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, ***in connection with a securities contract***, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

11 U.S.C. § 546(e) (emphasis added). The Defendants assert that the payments for their shares were "settlement payments" to a "financial institution" in connection with a "securities contract." In response, the Trustee argues that (1) the safe harbor is inapplicable to creditors who assert fraudulent transfer claims under state law; (2) the safe harbor "does not apply to initial transferees like Water Street and Wind Point who participated and were complicit in the fraud;" (3) the payments to the Selling Shareholders do not constitute "settlement payments" or "securities transactions" under section 546(e). The Court will now address each of these arguments.

A. Preemption of Individual Creditor Claims

In the first of its arguments, the Trustee asserts that the safe harbor is inapplicable to claims asserted by a litigation trust under state fraudulent transfer law. He argues that because section 546(e) only bars avoidance actions brought by an estate representative, a litigation trust may assert claims under state fraudulent transfer law so long as such claims were assigned by the creditors. The Defendants, however, allege that section 546(e) preempts state fraudulent transfer law with respect to these claims. Relying primarily on *Whyte v. Barclays Bank PLC*, they note that the Trust, as a creation of the Debtor's chapter 11 plan of reorganization, is barred from bringing any fraudulent transfer claims on behalf of Physiotherapy's creditors. 494 B.R. 196 (S.D.N.Y. 2013) ("*Barclays*").[3]

Neither party disputes that the safe harbor of section 546(e) applies to claims brought by a trustee in bankruptcy under section 544(b). The law, however, is less clear with respect to post-confirmation assignees of creditor claims, and courts in this and other jurisdictions have reached differing conclusions based on the unique facts and circumstances of each case. The United States District Court for the District of Delaware addressed a similar scenario in *PHP Liquidating, LLC v. Robbins*, 291 B.R. 603 (D. Del. 2003). In that case, the debtor filed a voluntary petition for relief under chapter 11. *Id*. at 605. PHP LLC was established pursuant to the debtor's plan of liquidation to "liquidate assets of PHP Corporation in furtherance of the Plan and for the sole benefit of PHP LLC's members, ***who were the creditors of PHP Corporation.***" *Id.* (emphasis added). In holding that PHP LLC was not prohibited from asserting avoidance actions under Delaware state law, the Court determined that section 546(e) was inapplicable because "PHP LLC has not asserted its claims against Movants in the capacity of a trustee or as a successor-in-interest to a trustee or debtor-in-possession. Rather, ***PHP LLC is bringing the instant claims as a direct assignee of the unsecured creditors***." *Id*. at 607 (emphasis added). The Trustee encourages the Court to follow the *PHP* ruling.

In *Barclays*, however, the United States District Court for the Southern District of New York reached the opposite conclusion. 494 B.R. at 201. In that case, the debtor's plan established a litigation trust to prosecute certain claims pertaining to the bankruptcy. *Id*. at 198. Pursuant to the terms of the plan, the debtors, the debtors' estates, and certain creditors assigned "'any and all'

[3] As will be discussed *infra*, the Defendants also encourage the Court to adopt the reasoning set forth in *Deutsche Bank Trust Co. Ams. v. Large Private Beneficial Owners (In re Tribune Co. Fraudulent Convenayce Litig.)*, 2016 U.S. App. LEXIS 5787, at *39 (2d Cir. 2016), a decision which was issued following completion of briefing in this case and which led to the parties' submission of letter memoranda.

of their claims to the Trust, [including] avoidance actions arising under Chapter 5 of the Bankruptcy Code and state law causes of action otherwise available to the debtors who transferred their claims to the Trust." *Id*. at 198. Relying on the policy behind the section 546(g) safe harbor[4], the court articulated that Congress' concern of promoting stability in the commodities markets would be severely undermined if debtors could avoid swap transactions simply by transferring their claims to a litigation trust and "repackag[ing] them as creditors' state law fraudulent conveyance claims." *Id*. at 200-01. The court thus held that section 546(g) preempted state fraudulent claims brought by a litigation trustee acting as an assignee. *Id*. It concluded that permitting a litigation trustee to assert state law fraudulent transfer claims would create a substantial obstacle to Congress' objective of ensuring stability in the derivatives, commodities and swaps markets. *Id*.

Six months after the issuance of *Barclays* decision, another district judge in the Southern District of New York reached yet a different conclusion in *In re Tribune Co. Fraudulent Conveyance Litig.*, 499 B.R. 310 (S.D.N.Y. 2013) (hereinafter, "*Tribune I*"). The court in *Tribune I* rejected the defendant's express and field preemption arguments in determining that the plain language of section 546(e) provided no basis for the argument that Congress intended to occupy the entire field of fraudulent transfer law. *Id*. at 315-16. The *Tribune I* case, however, addressed consolidated state law claims asserted by individual creditors, and the court distinguished *Barclays* by noting the absence of a litigation trustee. *Id*. at 319 ("By contrast, the Individual Creditors here, unlike [the litigation trust in *Barclays*], are not creatures of a Chapter 11 plan, and they are in no way identical with the bankruptcy trustee; as a result, there is no reason why Section 546(e) should apply to them in the same way that Section 546(g) applied to [the debtor in *Barclays*].").

[4] Section 546(g) is another limitation on a trustee's avoidance powers and protects transfers made to "swap participant[s]" or "financial participant[s]." 11 U.S.C. § 546(g).

Shortly afterwards, the U.S. Bankruptcy Court for the Southern District of New York provided further rationale for the argument that Congress did not intend to preempt state law in enacting section 546(e), *Weisfelner v. Fund 1 (In re Lyondell Chem. Co.)*, 503 B.R. 348 (Bankr. S.D.N.Y. 2014) ("*Lyondell*"). The debtor's plan established a trust to pursue any claims the creditors might have had as a result of Bassell AF S.C.A.'s leveraged acquisition of Lyondell Chemical Company. *Id*. at 353-54. Acting as an assignee of creditors' claims, the trustee only sought relief via state law claims[5] and attempted to avoid approximately $6.3 billion in payments made to selling shareholders in the LBO. *Id*. at 355. The court concurred with the *Tribune I* court and concluded that section 546(e) does not apply to individual creditors asserting fraudulent transfer claims under state law. *Id*. In doing so, the court engaged in an extensive analysis of the defendants' assertion that section 546(e) preempted state law. *Id*. at 359. Beginning with the presumption that "the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress," the court concluded that: (1) there was no express preemption as Congress failed to explicitly state its intention to displace state fraudulent transfer law, *Id*. at 361; (2) there was no field preemption as federal and state fraudulent transfer statutes have coexisted for many years, and Congress never demonstrated any intent to "occupy the field" of fraudulent transfer law, *Id.* at 362-63; and (3) there was no conflict preemption under both the impossibility branch and the obstacle branch, *Id*. at 363-73. With respect to the "obstacle branch," the court noted that a finding of conflict preemption was appropriate "where state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Id*. at 363 (citations omitted). The court then discussed the

[5] In *Lyondell*, multiple trusts were created to pursue claims on behalf of the debtor's creditors and the estate. The *Lyondell* decision addressed claims brought by a creditor trust under state law while a separate trust was established to pursue claims under section 548 of the Code.

different policies reflected in the Code, the safe harbors and fraudulent transfer law and concluded that "[n]othing in the legislative history of the existing law evidences a desire to protect individual investors who are beneficial recipients of insolvents' assets." *Id*. at 373. Noting that the safe harbors' purpose is to protect *markets* from systemic risk, the court concluded that the Code's policy of "traditional priority of creditors of insolvent companies over those companies' stockholders" trumped the safe harbor when there was no countervailing policy in support of its applicability. *Id*. at 369.

The Second Circuit recently resolved the divide within the New York Federal Courts, and the Court granted the parties additional time to submit supplemental briefing. In *In re Tribune Company Fraudulent Conveyance Litigation*, the Second Circuit Court of Appeals disagreed with the district court and determined that section 546(e) preempts state fraudulent transfer law. *Deutsche Bank Trust Co. Ams. v. Large Private Beneficial Owners (In re Tribune Co. Fraudulent Conveyance Litig.)*, 2016 U.S. App. LEXIS 5787, at *39 (2d Cir. 2016) (hereinafter, "*Tribune II*"). After concluding that it could not necessarily infer that the Code provides for a reversion of fraudulent transfer claims to creditors, the Court emphasized that "[e]very congressional purpose reflected in Section 546(e), however narrow or broad, is in conflict with appellants' legal theory." *Id*. The panel began by noting that "[t]he narrowest purpose of Section 546(e) was to protect other intermediaries from avoidance claims seeking to unwind a bankrupt intermediary's transactions that consummated between customers." *Id*. at *40-41 (citing H.R. Rep. No. 97-420). It next discussed the policy concerns implicated by the creditors' theory of recovery. In doing so, the court noted that the finality of securities transactions is essential to maintaining an efficient secondary market for common stocks. *Id*. at 45. It also articulated that enabling this type of circumvention of the safe harbor would discourage investors from maintaining a diversified portfolio as it would increase the monitoring costs any time a buyer wishes to initiate a tender offer of a public company. *Id.* at 47-48. Additionally, the court reasoned that permitting such claims would undermine numerous policies codified in the federal securities laws and would discourage firms from upholding their fiduciary duties when their company is up for sale. *Id*. at 49.

Although *Tribune II* settled the split in the Second Circuit, it is nevertheless not binding on the Court. The Court finds the reasoning in *Lyondell* more persuasive and therefore adopts its holding. Because "the purpose of Congress is the ultimate touchstone in every pre-emption case," the Court must look to the purpose and legislative history behind the safe harbors and section 546(e) before it determines whether or not the claims are preempted. *Wyeth v. Levine*, 555 U.S. 555, 565 (2009) (quoting *Medtronic, Inc. v. Lohr,* 518 U.S. 470, 485, 116 S. Ct. 2240, 135 L. Ed. 2d 700 (1996)). The Court believes that the *Lyondell* opinion more accurately addresses the history and function of the safe harbors. The second touchstone of preemption analysis, as articulated by the *Wyeth* court, is that "[i]n all pre-emption cases, and particularly in those in which Congress has legislated . . . in a field which the States have traditionally occupied . . . we start with the ***assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress***." *Id*. (quoting *Rice v. Santa Fe Elevator Corp.,* 331 U.S. 218, 230 (1947)) (emphasis added). Once again, the Court believes that the *Lyondell* decision correctly recognized that the States have traditionally occupied the field of fraudulent transfer law, and applying the presumption against preemption is therefore appropriate.

It should be noted that the safe harbors[6] were initially enacted to protect commodities clearing agencies from massive liability based on the theory that avoidance of margin payments

[6] In this context, the term "safe harbor" refers to a provision in the Code that grants special protections to holders of certain financial instruments including "the ability to exercise contractual rights allowing liquidation, termination or acceleration of derivative contracts upon bankruptcy, set off or net derivative

could present significant systemic risk in the derivatives market. AMERICAN BANKRUPTCY INSTITUTE COMMISSION TO STUDY THE REFORM OF CHAPTER 11, FINAL REPORT AND RECOMMENDATIONS 94 (2014), available at http://commission.abi.org/full-report (citing S. Rep. No. 95-989, at 8 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787) (noting that the safe harbors "find their origins in sections 362(b)(6) and 746(c) of the Bankruptcy Code to promote stability in the commodities market"). Because commodities transactions often contemplate future performance by parties to the transaction, avoiding margin or settlement payments to a clearinghouse may create a "ripple effect" as the failure of a clearinghouse could adversely impact all market participants. *See, e.g.*; H.R. Rep. No. 97-420, at 1; *see also* Stephen J. Lubben, *The Bankruptcy Code Without Safe Harbors*, 84 AM. BANKR. L.J. 123, 129-30 (2010). Congress posited these concerns in response to the *Ira Haupt* decision and other cases which concluded that transfers made to clearing associations were subject to avoidance actions, and this policy concern was at the forefront of their enactment. *See, e.g.*, *Lyondell,* 503 B.R. at 369-70 (citing *Seligson v. New York Produce Exch.*, 394 F. Supp. 125 (S.D.N.Y. 1975) ("*Ira Haupt*").

Although the safe harbors were later amended to include other securities, the one constant was the idea that "certain protections are necessary to prevent the insolvency of one commodity or securities firm from spreading to other firms and [possibly] threatening the collapse of the affected market." H.R. Rep. No. 97-420, at 1. With respect to section 546(e) and ordinary stock transactions,[7] the concern appears to relate to claims filed against non-beneficial owners of

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contracts free of the automatic stay, and broad immunity from avoidance actions." Stephen J. Lubben, *The Bankruptcy Code Without Safe Harbors*, 84 AM. BANKR. L.J. 123, 129 (2010).

[7] Indeed in the context of ordinary stock trades, the clearing agency plays a very similar role. The Third Circuit has noted that in a settlement system, "a third-party clearing agency acts as an intermediary between an anonymous buyer and seller." *Brandt v. B.A. Capital Co. LP (In re Plasssein Int'l Corp.),* 590 F.3d 252, n. 1 (3d Cir. 2009). Because actual delivery of a security doesn't take place until three days after the execution of a trade, the clearing agency serves to mitigate the risks involved during this period by standing ready to perform in the event that a party to the trade fails to do so. *Id*. Thus, clearing agencies and broker-

securities who facilitate trading activity, i.e. financial institutions. *See, e.g.*, *Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives, Hearing Before the H. Subcomm. On Regulatory Reform, Commercial and Antitrust Law*, 113th Cong. 16 (2014) (statement of the Honorable Christopher S. Sontchi, U.S. Bankruptcy Judge for the District of Delaware) ("Securities industry transferees generally are not the beneficial owners of the subject transactions but, rather, are the conduits."). Because broker-dealers and clearinghouses serve to enhance the liquidity of the nation's financial markets and help to mitigate counterparty risk, fraudulent conveyance claims filed against such entities may negatively impact the U.S. economy as a whole. *See id.* The *Lyondell* court acknowledged this in holding that avoidance of payments made to final recipients of a cash tender offer fail to implicate these concerns. Moreover, even the *Barclays* decision, which involved the avoidance of various swap transactions between the debtor and a major financial institution, was quick to point out this concern.[8] 494 B.R. at 197. In sum, both the written decisions and legislative history suggest that sections 546(e) and 546(g) were enacted to further augment the protections against systemic risk codified in the initial safe harbors.

As noted in *Lyondell*, some of the policy concerns voiced by the *Tribune II* court find minimal support when scrutinizing the Congressional record. In reaching its decision, the Second Circuit relied on a line of cases for the proposition that the safe harbors were enacted to promote finality for individual investors. *See Tribune II*, 2016 U.S. App. LEXIS 5787, at *44-45 (citing *In re Kaiser Steel Corp.*, 952 F.2d 1230, 1240 n.10 (10th Cir. 1991)). However, the Court believes that these cases have placed too much emphasis on certain themes that do not appear to have played a critical role in the drafting of the safe harbors. While the *Kaiser* court relied on the 1990 House

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dealers help to reduce the counterparty risk involved in the securities trade by assuming the risk of loss during this interim period. *Id*.

[8] The Court should note that the Defendants encouraged the Court to adopt the holding in *Barclays* prior to the Second Circuit's decision in *Tribune II*.

Report in addressing the policy behind the safe harbors, a thorough review of that document indicates that the purpose of the safe harbors is to mitigate the potential systemic risk of certain complex financial transactions. The majority of the report focuses on swaps and forward contracts and says little about the concerns mentioned in the *Kaiser* or *Tribune II* opinions. *See* H.R. Rep. 101-484 (1990) ("The purpose of H.R. 4612 is to ***ensure that the swap and forward contract financial markets are not destabilized*** by uncertainties regarding the treatment of their financial instruments under the Bankruptcy Code") (emphasis added). Furthermore, multiple federal courts have fundamentally disagreed with the holding in *Kaiser* and have concluded that prevention of systemic risk is the sole purpose of the safe harbors. *See, e.g., Lyondell*, 503 B.R. at 373 ("Nothing in the legislative history of the existing law evidences a desire to protect individual investors who are beneficial recipients of insolvents' assets. The repeatedly expressed concern, by contrast, has been that of protecting market intermediaries and protecting the markets—in each case to avoid problems of 'ripple effects,' i.e., falling dominos."); *Wieboldt Stores, Inc. v. Schottenstein,* 131 B.R. 655, 664 (N.D. Ill. 1991); *Munford v. Valuation Research Corp. (In re Munford, Inc.)*, 98 F.3d 604 (11th Cir. 1996); *Barclays*, 494 B.R. at 200 (quoting *Mary Jo C. v. N.Y. State and Local Retirement Sys.*, 707 F.3d 144, 162 (2d Cir. 2013)); *Tribune Co.*, 499 B.R. at 318; *Official Comm. of Unsecured Creditors of Norstan Apparel Shops, Inc. v. Lattman (In re Norstan Apparel Shops, Inc.)*, 367 B.R. 68, 76 (Bankr. E.D.N.Y. 2007).

While some courts have held that these policies do not trump the plain meaning of the term "security" for purposes of statutory interpretation, they are nonetheless highly relevant to the issue of conflict preemption. In order to conclude that a federal statute preempts a state statute under the "obstacle branch," a court must determine that "state law is an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Arizona v. United States*, 132 S.

Ct. 2492, 2515 (2012) (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67, 61 S. Ct. 399, 85 L. Ed. 581 (1941)). The issue therefore is straightforward: would allowing the Litigation Trust to pursue its state fraudulent transfer claims have a destabilizing effect on the financial markets Congress sought to protect? The Court believes the answer is clearly no. Unlike in *Barclays*, the Trustee is not seeking to avoid a large portfolio of swap transactions. And unlike in *Tribune*, there are no public shares involved. In this case, the two Controlling Shareholders owned over 90% of the Debtor's common stock. It is hard to envision a scenario where requiring Water Street and Wind Point to disgorge their payments would pose any sort of "ripple effect" to the broader secondary market. *See Lyondell*, 503 B.R. at 373 ("where the stockholders are the ultimate beneficiaries of the constructively fraudulent transfers, [they] can give the money back to injured creditors with no damage to anyone but themselves"); *see also Geltzer v. Mooney (In re MacMenamin's Grill Ltd.)*, 450 B.R. 414, 419 (Bankr. S.D.N.Y. 2011) ("These decisions note that granting a safe harbor to a constructively fraudulent private stock sale has little if anything to do with Congress' stated purpose in enacting section 546(e): reducing systemic risk to the financial markets."). Because permitting the trustee to pursue the Senior Noteholders' state law fraudulent transfer claims does not implicate these concerns, a finding of implied preemption is inappropriate.

The Court's conclusion that the safe harbor does not preempt state law fraudulent transfer claims in this context is further bolstered by the plain language of the statute itself. As noted by the Trustee at oral argument, section 546 is titled "limitations on avoidance powers" and section 546(e) only limits a *trustee's* ability to bring a fraudulent conveyance action. 11 U.S.C. § 546(e). The statute is silent with regard to a creditor's ability to bring such a claim. *Id*. As noted by the Trustee, Congress has explicitly stated in other sections of the Code when it intends for a provision to apply to entities other than the trustee. *See, e.g.*, 11 U.S.C. § 1109(b) ("A party in interest, including the debtor, the trustee, a creditors' committee, . . . a creditor, . . . or any indenture trustee, may raise and may appear and be heard on any issue in a case . . ."). Moreover, certain other Code provisions expressly preempt state law by incorporating phrases such as "notwithstanding any applicable law." *See*, *e.g.*, 11 U.S.C. § 541(c)(1) ("notwithstanding any . . . nonbankruptcy law"). No such language is included in section 546(e). Finally, the Trustee has noted that while Congress chose to expressly preempt avoidance actions seeking to clawback charitable contributions, it included no such provision in section 546(e). *See* 11 U.S.C. § 544(b)(2) ("***Any claim by any person*** to recover a transferred contribution described in the preceding sentence under Federal or State law in a Federal or State court ***shall be preempted by the commencement of the case*** "). The absence of this phrase in section 546(e) constitutes strong evidence "that Congress did not intend that section to preempt state-law avoidance claims." Trustee's Br. 6 (citing *Wyeth v. Levine*, 555 U.S. at 574-75).

An additional distinguishing factor is that the *Barclays* and *Tribune* defendants were not alleged to have acted in bad faith. While the Trustee asserts its participation argument with respect to the federal constructive fraudulent transfer claims, the Court also finds it helpful in the state law analysis as it implicates additional policy concerns relevant to the preemption analysis. Permitting a defendant to evade liability in this scenario vis-à-vis the safe harbor would run counter to Congress' policy of providing remedies for creditors who have been defrauded by corporate insiders. *See Tribune*, 499 B.R. at 317 ("Congress pursues a host of other aims through the Bankruptcy Code, not least making whole the creditors of a bankruptcy estate. It is not at all clear that Section 546(e)'s purpose with respect to securities transactions trumps all of bankruptcy's other purposes."); 5 *Collier on Bankruptcy* (16th ed. 2015) ("Collier") ¶ 548.01[a][1] ("Section 548 and fraudulent transfer law generally attempt to protect creditors from transactions which are designed, or have the effect, of unfairly draining the pool of assets available to satisfy creditors' claims."); *Official Comm. of Unsecured Creditors v. Fleet Retail Fin. Group (In re Hechinger Inv. Co. of Del., Inc.)*, 274 B.R. 71, 81 (D. Del. 2001) ("Fraudulent conveyance laws, such as the Bankruptcy Code and state statutes . . . are intended to prevent shareholders, secured creditors, and others from benefitting at the expense of others, including unsecured creditors."). Dismissing the Trustee's claim would undermine the other policy objectives outlined in the Code, namely, the distribution of a debtor's assets in accordance with the absolute priority rule and the protection of creditors when equityholders have been unjustly enriched at their expense. The Court does not believe that Congress intended to protect bad-faith transferees in situations such as this.

For the foregoing reasons, the Court concludes that the safe harbor does not bar the litigation trust from asserting its state law fraudulent transfer claims on behalf of the Senior Noteholders. Specifically, the Court holds that a litigation trustee may assert state law fraudulent transfer claims in the capacity of a creditor-assignee when: (1) the transaction sought to be avoided poses no threat of "ripple effects" in the relevant securities markets; (2) the transferees received payment for non-public securities, and (3) the transferees were corporate insiders that allegedly acted in bad faith. When these three factors are present, a finding of implied preemption is inappropriate.

B. The Participation Exception

The Trustee next argues that the safe harbor does not apply to its claims because the transferees allegedly participated in the fraud. Trustee's Br. 38. The Defendants, on the other hand, argue that there is no general fraud exception to the safe harbor. Because section 546(e) carves out an exception for intentional fraudulent transfers brought under section 548(a)(1)(A), the Defendants assert that Congress explicitly indicated that there are no similar exceptions for constructive fraudulent transfer claims brought under 548(a)(1)(B). *See Peterson v. Somers Dublin Ltd.*, 729 F.3d 741, 749 (7th Cir. 2013) ("If the Trustee were right that §546(e) is irrelevant when the debtor in bankruptcy had any role in a fraud, why did Congress add the exception referring to §548(a)(1)(A)?"); *Moore v. Martillo (In re CD Liquidation Co.)*, No. 09-13038 KG, 2012 Bankr. LEXIS 1759, at *2 n.1 (Bankr. D. Del. Mar. 23, 2012) (noting that claims brought under section 548(a)(1)(B) are not carved out under the safe harbor). The problem with this argument, however, is that the scienter requirement of section 548(a)(1)(A) pertains to the *transferor* and not the *transferee*. Where, as here, the Trustee alleges that the transferee actively participated in the fraud, the cases holding the safe harbor applicable to constructive fraudulent transfer claims -- despite a debtor's involvement in the fraud -- lose some persuasive value. Indeed, the Trustee cites two cases for the proposition that a recipient of Ponzi scheme payouts is not entitled to the safe harbor protections of section 546(e) where "[the] complaint sufficiently alleges that the transferee had actual knowledge of the underlying fraud." *See O'Connell v. Pension Fin. Servs. (In re Arbco Capital Mgmt., LLP)*, 498 B.R. 32, 42 (Bankr. S.D.N.Y. 2013) (citing *Sec. Investor Protection Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 2013 U.S. Dist. LEXIS 56042, at *22-23 (S.D.N.Y. Apr. 15, 2013)).

In response, the Defendants assert that these two cases are equally inapplicable because they involve investors receiving distributions from Ponzi schemes. In *Arbco and Madoff*, the "non-innocent investors" were fully aware that the fund was operating as a Ponzi scheme and therefore knew that the distributions were not actually "settlement payments" in connection with a legitimate "securities contract" as defined by section 546(e). *See SIPC*, 2013 U.S. Dist. LEXIS 56042, at *31 ("In the context of Madoff Securities' fraud, that goal is best achieved by protecting the reasonable expectations of investors who believed they were signing a securities contract; but a transferee who had actual knowledge of the Madoff "Ponzi" scheme did not have any such expectations, but was simply obtaining moneys while he could."). In other words, section 546(e) should protect innocent transferees who genuinely believed they were receiving payments on account of a securities contract but not those who knew there was no underlying trading activity. It is unclear whether or not the courts would have denied safe harbor protection to the bad-faith transferees had the transactions involved actual securities.

Because the Selling Shareholders received payments on account of legitimate equity securities, the Court concludes that the Physiotherapy sale is distinguishable from the facts of Ponzi scheme cases. While this may be a particularly harsh result, the plain language of the statute is inescapable. The bad-faith transferees in *Madoff* were denied safe harbor protection because there was no actual security involved in the transaction. While transactions involving "fake securities" do not fall under the purview of the statute, there is no similar limiting language for insider transferees who allegedly acted in bad faith. *See, e.g.*, *Hechinger,* 274 B.R. at 87 ("The statute itself has no exception to its application that is based on the status of the selling shareholder"). As a result, the Court concludes that, as the statute is currently written, there is no exception for insiders who allegedly acted in bad faith.

C. "Settlement Payment" and "Securities Contract"

The Trustee argues that the payments made to selling shareholders were not "settlement payments" in connection with a "securities contract." Because the Defendants shares were converted into certificates redeemable for cash prior to the merger's closing, the Trustee argues that these certificates were not securities. The Court finds that this interpretation is inconsistent with the broad reaching language of section 546(e). First, the statute simply requires that the "settlement payment" be made ***in connection with*** a "securities contract." 11 U.S.C. § 546(e) (emphasis added). Section 741(8) of the Code defines a "settlement payment" as "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). Section 101(49)(A) includes in its definition of "securities" a "certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase or sell, a security." 11 U.S.C. § 101(49)(A)(xv).

The Merger Agreement, which the Trustee clearly relied upon in drafting the Complaint, explicitly defines the scope and purpose of the certificates. Article 4 of the Agreement deals specifically with the closing and merger consideration. Moreover, Section 4B states that prior to the effective time, the certificates "represented shares of Company Capital Stock." Def.'s Ex. 3. This falls squarely within the Code's definition of a "security" as it constitutes "stock," 11 U.S.C. § 101(49)(A)(ii), or alternatively, a certificate representing the right to sell a security, 11 U.S.C. § 101(49)(A)(iv)).

Whether the transfer qualifies as a "settlement payment," the Court is bound by the Third Circuit's decision in *Resorts* which concluded that "[a] payment for shares during an LBO is obviously a common securities transaction, and we therefore hold that it is also a settlement payment for the purposes of section 546(e)." *Lowenschuss v. Resorts Int'l, Inc. (In re Resorts Int'l, Inc.)*, 181 F.3d 505, 516 (3d Cir. 1999). In *Resorts*, the Third Circuit determined that the definition of the term "settlement payment" was broad enough to encompass a "transfer of cash or securities made to complete a transfer payment." *Id*. at 515 (citing *Kaiser Steel Corp. v. Charles Schwab & Co.*, 913 F.2d 846, 849 (10th Cir. 1990)). The fact that the Defendants' shares were converted into certificates does not overcome the broad scope of section 546(e) nor is it enough for the Court to ignore its directive that "[a] payment for shares during [a leveraged buyout] is obviously a common securities transaction . . . [and] also a settlement payment." *Brandt v. B.A. Capital Co. LP (In re Plassein Int'l Corp.)*, 590 F.3d 252, 258 (3d Cir. 2009) (citing *Resorts*, 181 F.3d at 516)). The Court will not elevate form over substance in light of this binding authority. The Court believes this view to be consistent with the Third Circuit's position that section 546(e) should be interpreted liberally. *See, e.g.*, *Resorts*, 181 F.3d at 515 (recognizing that payment used to complete an LBO is a "settlement payment"); *Plassein*, 590 F.3d at 258 (noting that the *Resorts Court* rejected that argument that a "settlement payment" must transfer through the settlement system).

II. Ratification

The Defendants next assert that the Senior Noteholders ratified the fraudulent transfer when they purchased their securities. More specifically, they argue that because the Secured Noteholders were aware that the proceeds from the issuance would be used to cash out the Selling Shareholders,[9] they are estopped from seeking to avoid the very transfer they allegedly approved. Relying primarily on *Lyondell*, the Defendants encourage the court to adopt the view that "[c]reditors who authorized or sanctioned the transaction, or, indeed, participated in it themselves, can hardly claim to have been defrauded by it, or otherwise to be victims of it." 503 B.R. at 383-84. In the *Lyondell* case, the court noted that a creditor's knowledge that it was lending "for the purpose of financing an LBO, and that the LBO proceeds would go to the stockholders" was sufficient to establish a ratification defense. *Id*. at 385.

In response, the Trustee claims that the Senior Noteholders could not have possibly ratified the transaction because they purchased the notes in reliance on fraudulent financial statements.

[9] The first page of the OM states that "[t]he proceeds of the notes will be used to finance a portion of the consideration for the acquisition of Physiotherapy, to repay all of Physiotherapy's existing debt and to pay transaction fees and expenses." D368.

The Trustee believes that the appropriate question to ask is whether the bondholders "had full knowledge of all material facts" surrounding the transaction. *ASARCO LLC v. Americas Mining Corp.*, 396 B.R. 278, 427 (S.D. Tex. 2008).

Ratification "is the act of knowingly giving sanction or affirmance to an act which would otherwise be unauthorized and not binding." 57 N.Y. Jur.2d Estoppel, Ratification and Waiver § 87 (2007). This defense "implies assent, express or implied, and a change of position on the part of one who acts in reliance on such assent." *Id*. With regard to complex transactions, courts have noted that "[w]here the allegedly ratifying party's silent acquiescence to a transaction credibly appears to have resulted from the complexity of the situation rather than intent, ratification does not occur." *Adelphia Recovery Trust v. HSBC Bank USA (In re Adelphia Recovery Trust),* 634 F.3d 678, 693-94 (2d Cir. 2011) (citing *King v. Ionization Int'l, Inc.*, 825 F.2d 1180, 1187 (7th Cir. 1987) (Posner, J.)). Other courts have held that this defense is applicable "only if [the creditor] actually participated in structuring the transaction that damaged creditors." *In re Tronox*, 503 B.R. 239, 276 (Bankr. S.D.N.Y. 2013). *See also In re Refco, Inc. Sec. Litig.*, No. 07 MDL 1902 GEL, 2009 WL 7242548, at *11 (S.D.N.Y. Nov. 13, 2009), *report adopted*, 2010 WL 5129027 (S.D.N.Y. Jan. 12, 2010) (noting that the transferee was "heavily involved in structuring the transaction for the purchase of PlusFunds shares). In the *Tronox* case, the court determined that because the defendants "did not establish that the bondholders knowingly gave sanction to the fraudulent conveyances complained of in this case," a finding of ratification was inappropriate. *Id*. Both the *Adelphia* court and the *Tronox* court appeared to endorse the material facts test articulated in *ASARCO*.

Contrary to the Defendants' assertions, the use of proceeds is simply one piece of the entire "fraud alleged in the complaint." *Refco*, 2009 WL 7242548, at * 10. As a result, the Court concludes that there is a material dispute as to whether or not the Senior Noteholders had knowledge of the material facts surrounding the transaction. With respect to a bond issuance, the borrower's financial health may be the most material fact. Companies rely on cash flow to service their debts. A firm with poor cash flows may find itself unable to pay its debts as they come due. Clearly, this information is highly pertinent to a reasonable investor's decision to lend money to a company. Simply put, the Trustee has advanced sufficient allegations to suggest that the Senior Noteholders may have been misled into lending money to a company whose financial health was poorer than represented. Because intent is the central element of ratification, it is far from certain that the Senior Noteholders intended to extend credit to an insolvent company. Rather, the bondholders "simply bought into [the transaction] based on the information available to them." *Tronox*, 503 B.R. at 276. That information, as expressed in the OM, did not indicate that the Debtor was on the brink of insolvency. While the Court will not resolve any factual dispute in a motion to dismiss, it is clear from even the most cursory glance at the OM that an investor in the Senior Notes may have believed that the Debtor's interest coverage and working capital made it a non-risky borrower. *See* Def.'s Ex. 7, D415 (net income increased from minus $5,601,000 in 2009 to positive $20,627 and $48,981 in 2010 and 2011 respectively). Thus, a finding of ratification is inappropriate at this juncture.

Notwithstanding the above, the Defendants encourage the court to follow the reasoning in *Lyondell* and argue that the facts presented parallel those in that case. The Court finds the *Lyondell* case highly distinguishable because, as noted at oral argument, there were no allegations that the *Lyondell* lenders relied on false financial statements. The creditors knew they were participating in a leveraged buyout that carried potential risk. Here, the transaction was financed with a $213.3 million equity infusion. In other words, the risk associated with the notes may have been more apparent in *Lyondell*. Even the court itself acknowledged that "more nuanced knowledge might be necessary to establish ratification in other contexts." *Lyondell*, 503 B.R. at 385. The Court finds that given the unique facts of this case, the Senior Noteholders did not ratify the sale of Physiotherapy,

III. The Release

Eight months after the Transaction closed, Court Square and the Defendants entered into that certain agreement (the "Release") containing a general release of claims. The Release bars any "claims for losses, damages, indemnification, or other payment" against any party "for any breach, violation or inaccuracy of any of the terms, conditions, covenants, agreements or representations and/or warranties in the Merger Agreement." Def.'s Ex. 8 (Release) at 1-2 (D537-38). Additionally, the parties "irrevocably waive[d] all such claims, whether in law, equity, tort or otherwise, whether or not known now, heretofore or hereafter, whether anticipated or unanticipated, suspected, unsuspected or claimed, fixed or contingent." *Id*. The Defendants argue that the Release prohibits the Trustee from asserting certain counts of the Complaint. In response, the Trustee asserts that because avoidance actions are not derivative of a debtor's pre-petition legal interests, the waiver is unenforceable with respect to post-confirmation vehicles.

Section 541 of the Code provides that the bankruptcy estate is comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). This includes whatever causes of action the debtor may have possessed prior to the petition date. 7 *Collier on Bankruptcy* ¶ 323.03[2]. Thus, a trustee may assert a claim "as successor to the debtor's interest included in the estate under section 541 or those assigned to the trustee against third parties for the benefit of the estate." The Third Circuit has explicitly noted that because the trustee stands in the shoes of the debtor when bringing these claims, it is also "subject to the same defenses as could have been asserted by the defendant had the action been instituted by the debtor.'" *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 356 (3d Cir. 2001) (quoting *Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 885 F.2d 1149, 1154 (3d Cir. 1989)). In *Lafferty*, the court concluded that because the debtor and the defendants had both contributed to the fraud alleged, the trustee was barred from asserting its claims under the *in pari delicto* doctrine. *Id*. at 360. The Third Circuit determined that the plain language of section 541 provides specifically that a court may not take into consideration a trustee's "clean hands" in the wrongdoing, and it was irrelevant that the trustee had no role in the fraud. *Id*. This analysis changes, however, when a trustee files a claim under one of the Code's avoidance powers. In *McNamara v. PFS*, the Third Circuit determined that section 548 provides no similar limiting language, and a court may therefore consider events such as the appointment of a trustee in determining whether a defendant may assert an affirmative defense such as *in pari delicto*. *McNamara v. PFS (In re Personal & Bus. Ins. Agency)*, 334 F.3d 239, 245 (3d Cir. 2003) ("The Lafferty Court made clear that its holding did not extend to actions brought under Code sections other than 541"). As a result, the Court may take into account the fact that the Trustee and the creditors were not parties to the Release.

The Court concludes that because the Trustee was not a party to the Release, he is not bound by the terms of the agreement. Post-petition avoidance actions "can only be brought by the trustee after the petition is filed . . . and the [pre-petition debtor] does not own the right to pursue a fraudulent transfer claim in bankruptcy." *Official Comm. of Unsecured Creditors v. UMB Bank (In re Residential Capital, LLC)*, 497 B.R. 403, 414 (Bankr. S.D.N.Y. 2013). It follows that the pre-petition debtor may not waive such claims either. The avoidance powers under the Code are within the unique purview of the trustee, and courts have noted that "prior to bankruptcy a debtor may not waive bankruptcy rights that inure to the benefit of unsecured creditors not a party to that waiver." *Minnesota Corn Processors, Inc. v. American Sweeteners, Inc. (In re American Sweeteners Inc.)*, 248 B.R. 271, 276 (Bankr. E.D. Pa. 2000). This conclusion is further supported by the Third Circuit's decision in *Hays,* where similar to here, the debtor had entered into a pre-petition arbitration agreement. *Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 885 F.2d 1149 (3d Cir. 1989). In holding that all of the trustee's section 541 claims were subject to mandatory arbitration, the court concluded that for purposes of avoidance actions, the trustee does *not* stand in the shoes of the debtor as such claims are "not derivative of the bankrupt." *Id*. at 1155. Further, claims under section 548 are "creditor claims that the Code authorizes the trustee to assert on their behalf," and "there is no justification for binding creditors to an arbitration clause with respect to claims that are not derivative from one who was a party to it." *Id*. The Court concludes that the situation here is virtually tantamount to that in *Hayes*, and for the reasons articulated above, the Trustee is not bound by the Debtor's Release. It should be noted that the case relied on by Defendants, *AgFeed*, reached a different conclusion on a similar issue. *JLL Consultants, Inc. v. Hormel Foods Corp. (In re AgFeed USA, LLC)*, 2015 Bankr. LEXIS 4272 (Bankr. D. Del. Dec. 15, 2015). However, as noted by the Trustee at oral argument, the parties in *AgFeed* never briefed the issue of whether a pre-petition release may be binding on a trustee, and the defendant never argued that the release was a bar to the section 548 claims. The court's decision was justified by the unique facts and circumstances of that case; however, because the opinion does not discuss the issue in detail, there is little the Court can take or infer from it other than its holding. Accordingly, the Court must reject the Defendants' contention that *AgFeed* trumps the Third Circuit's reasoning in *Hayes* and *McNamera*.

IV. Actual Fraudulent Transfer Claims

The Defendants' final categorical objection is that the Complaint fails as a matter of basic pleading. Neither party disputes that the heightened pleading standard of Rule 9(b) applies to the actual fraudulent transfer claims. The Third Circuit provided some guidance on how to apply this standard in *Seville* by concluding that:

> We approach this question mindful of our recent admonition that in applying Rule 9(b), focusing exclusively on its 'particularity' language 'is too narrow an approach and fails to take account of the general simplicity and flexibility contemplated by the rules.' . . . ***Rule 9(b) requires plaintiffs to plead with particularity the "circumstances" of the alleged fraud in order to place the defendants on notice of the precise misconduct of which they are charged***, and to safeguard defendants against spurious charges of immoral and fraudulent behavior. It is certainly true that allegations of "date, place or time" fulfill these functions, but nothing in the rule requires them. Plaintiffs are free to use alternative means of injecting precision and some measure of substantiation into their allegations of fraud.

Seville Indus. Mach. Corp. v. Southmost Mach. Corp., 742 F.2d 786, 791 (3d Cir. 1984) (emphasis added).

In *Liberty State Benefits*, the Court held that under Rule 9(b), intent need only be alleged generally. *Barry v. Santander Bank, N.A. (In re Liberty State Benefits of Del., Inc.),* 541 B.R. 219, 240-41 (Bankr. D. Del. 2015) (citing *Iqbal*, 556 U.S. at 687)). Circumstantial evidence that the defendants intended to commit fraud was sufficient to survive a motion to dismiss. *See id.* at 241. The Court concluded that such a holding is consistent with Supreme Court precedent and the plain language of the statute itself. FED. R. CIV. P. 9(b) ("Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally"). In *Green Field Energy*, the Court concluded that because intent is often impossible to prove directly, courts may infer intent by evaluating the circumstances of the transaction and looking for the presence of certain badges of fraud. *Halperin v. Moreno (In re Green Field Energy Servs.)*, 2015 Bankr. LEXIS 2914, at * 20 (Bankr. D. Del. Aug. 31, 2015) (citing *Liquidation Trust of Hechinger Inv. Co. of Del. v. Fleet*

Retail Fin. Grp. (In re Hechinger Inv. Co. of Del.), 327 B.R. 537, 550-51 (D. Del. 2005)). With respect to both intent and the other elements of the claims, "[t]he requirements of Rule 9(b) are relaxed and interpreted liberally where a trustee, or trust formed for the benefit of creditors, as here, is asserting the fraudulent transfer claims . . . ." *Official Comm. of Unsecured Creditors of Fedders N. Am., Inc. v. Goldman Sachs Credit Partners L.P. (In re Fedders N. Am., Inc.)*, 405 B.R. 527, 544 (Bankr. D. Del. 2009) (citations omitted).

The Defendants argue that a heightened pleading standard must apply here. They assert that in order for the claims to survive a motion to dismiss, the Complaint must demonstrate that a "critical mass" of the Company's directors effectuated the transfer for the specific purpose of defrauding creditors. The Court finds this standard to be inconsistent with the caselaw discussed above. Because specific intent is difficult to prove at the motion to dismiss stage, allegations of "badges of fraud" are sufficient to overcome a Rule 12(b)(6) motion. *Liquidation Trust of Hechinger Inv. Co. of Del. v. Fleet Retail Fin. Grp. (In re Hechinger Inv. Co. of Del.)*, 327 B.R. 537, 550-51 (D. Del. 2005) (citations omitted). In making such a determination, courts have considered "(1) the relationship between the debtor and the transferee; (2) consideration for conveyance; (3) insolvency or indebtedness of the debtors; (4) how much of the debtor's estate was transferred; (5) reservation of benefits, control or dominion by the debtor; and (6) secrecy or concealment of the transaction." *Id*. The Court need not consider the critical mass theory in this context. The Controlling Shareholders held a ninety percent (90%) stake in the Company – by definition, they controlled the Board of Directors who had the power to appoint management. To argue that the actions of the Debtor's individual directors and officers cannot be imputed to Water Street and Wind Point ignores this basic fact. Accordingly, the badges of fraud are the proper standard.

The Trustee has alleged more than the requisite number of badges of fraud identified in *Hechinger*. With respect to factor one, the transferees were classic insiders of the Debtor. Water Street and Wind Point owned ninety percent of Physiotherapy's common stock, and the transfers here clearly constituted payments to insiders. With respect to factor two, the Complaint alleges that the cash consideration received by the Defendants was worth far more than the value of the shares. As discussed in the facts section, the Complaint clearly alleges numerous accounting inaccuracies that could potentially lead a reasonable fact finder to conclude that the Debtor's shares were grossly overvalued. It is also plausible to believe that these inaccuracies were far from accidental. Factor three, insolvency, is also met here as neither party disputes that the Debtor filed for bankruptcy protection shortly after the transfer. The Trustee does not allege the fourth or fifth badge, but there is a dispute with regard to the sixth. The Defendants note that because the marketing process was a robust one with full disclosure and due diligence, it is impossible to argue that the Controlling Shareholders concealed the Debtor's financials. Once again, the Court concludes that this argument overlooks the basic fact that the numbers relied upon were the product of alleged accounting fraud. While the Court acknowledges that the buyers were represented by their own independent investment bankers and accountants, there are ample allegations in the Complaint which support a plausible inference that Water Street and Wind Point intentionally manipulated the Debtor's earnings in order to maximize the proceeds for their shares. Accordingly, the motion to dismiss the actual fraudulent transfer claims is denied.

CONCLUSION

For the aforementioned reasons, the Court will deny the Motion with respect to the actual fraudulent transfer claims as well as the claims brought directly under state law (Counts I and VII). The Court will grant the Motion with respect to the federal constructive fraudulent transfer claims and the constructive fraudulent transfer claims brought under section 544 (Counts II, IV and V).

Dated: June 20, 2016

KEVIN GROSS, U.S.B.J.

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re	)	Chapter 11
	)	
PHYSIOTHERAPY HOLDINGS, INC., et al.,	)	Case No. 13-12965(KG)
	)	
Debtors.	)	
	)	
PAH LITIGATION TRUST,	)	
	)	
Plaintiff,	)	
	)	
v.	)	Adv. Proc. No. 15-51238(KG)
	)	
WATER STREET HEALTHCARE PARTNERS, L.P., *et al.*,	)	
	)	
Defendants.	)	
	)	**Re: D.I. 106**

ORDER

Defendants, Water Street Healthcare Partners.; WS Associate Co-Invest Partners, LLC; Water Street Healthcare Management, L.P.; Wind Point Partners IV, L.P.; Wind Point IV Executive Advisor Partners, L.P.; Wind Point Associates IV, LLC; and Wind Point Investors IV, L.P. ("Defendants") moved to dismiss the Complaint (the "Motion"). D.I. 106. The Court carefully considered the parties' briefs, oral arguments and supplemental submissions. For the reasons contained in the accompanying Opinion, IT IS ORDERED that:

1. The Motion is granted with respect to Counts II, IV and V.

2. The Motion is denied with respect to Counts I and VII.

3. The Trustee of the Plaintiff Trust filed Evidentiary Objections to exhibits which Defendants submitted with the Motion. Defendants responded in support of the 20 exhibits (the "Exhibits") they submitted. The Exhibits can be categorized as follows: Integral to the Complaint,

Part of the Chapter 11 proceeding, relied upon in the Complaint, and a section from the AICPA regarding Health Care Service Revenue and Related Receivables. The Court finds that with the exception of the AICPA document, the Exhibits are matters of public record (including documents filed in the Chapter 11 case) or documents that form the basis of the Trustee's claims. *See Lum v. Bank of Am.*, 361 F. 3d 217, 221 n. 3 (3d Cir. 2004); *Oshiver v. Levin, Fishein, Sedran & Berman*, 38 F. 3d 1380, 1384 n. 2 (3d Cir. 1994). The Court will therefore allow all of the documents to be admitted except the AICPA document. The AICPA document is not part of the Complaint and is not a document that forms the basis of the Trustee's claims. The Court therefore strikes the AICPA document.

Dated: June 20, 2016

Kevin Gross

KEVIN GROSS, U.S.B.J.