Fraudulent Transfer Is The Bomb! Fallout From In Re Dynegy

On Oct. 1, 2012, Dynegy Inc. (Dynegy) announced that it had emerged from Chapter 11 bankruptcy protection; mere weeks after Judge Cecelia G. Morris of the United States Bankruptcy Court for the Southern District of New York, Poughkeepsie Division, approved Dynegy and its wholly owned subsidiary, Dynegy Holdings LLC's (Dynegy Holdings), joint Chapter 11 plan of reorganization.

Indeed, Dynegy had filed for Chapter 11 bankruptcy protection only three months earlier in June 2012. However, this seemingly swift exit from bankruptcy met with some challenge, particularly in the wake of claims of actual and constructive fraudulent transfers made by Dynegy prior to the bankruptcy, as concluded by Susheel Kirpalani, the court-appointed examiner for Dynegy Holdings (examiner).

Fraudulent Transfer Law

Section 548 of the United States Bankruptcy Code provides for the avoidance of transfers that are either actual or constructively fraudulent. Section 548 provides, in pertinent part:

(a)(1) The trustee may avoid any transfer ... of an interest of the debtor in property, or any obligation ... incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily –

(A) made such transfer or incurred such obligation with actual intent to hinder, delay or defraud any entity to which the debtor was or become, on or after the date that such transfer was made or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

(B)(i) received less than reasonably equivalent value in exchange for such transfer or obligation; and (ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation; (II) was engaged in a business or a transaction ... for which any property remaining with the debtor was an unreasonably small capital; (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debt's matured ...

The standard for actual fraudulent transfer involves the intent to hinder, delay or defraud any creditor and is more stringent and thus oftentimes more difficult to prove, than the standard for constructive fraudulent intent, which provides that a transfer is fraudulent if the debtor does not receive "a reasonably equivalent value in exchange" and that the debtor is insolvent at the time or as a result of the transaction.

The circumstances surrounding the Dynegy bankruptcy case shows the extent to which a claim of fraudulent transfer can impact a debtor in its bankruptcy restructuring efforts. Ironically, the examiner's report detailing Dynegy's fraudulent transfers of billions in assets yielded a positive result — plan confirmation.

The examiner Drops a Bomb

On Nov. 7, 2011, Dynegy Holdings filed for Chapter 11 bankruptcy protection in the Southern District of New York. On Jan. 11, 2012, the bankruptcy court appointed the examiner to investigate Dynegy Holdings' reorganization of its business and restructuring of its debts in the months leading up to its bankruptcy filing. The court ordered the examiner to file a report containing his independent findings within 60 days and also charged with serving as a court appointed mediator to forge agreement on a Chapter 11 plan.

On March 9, 2012, examiner filed his 173 page report, a tomb addressing the prepetition transfer of Dynegy Holdings' interest in certain coal power plants, valued at $1.25 billion, to Dynegy. The examiner evaluated Dynegy Holdings' reorganization and restructuring efforts and found that the company had intentionally engaged in a multistep plan to avert defaults on secured debt and to reduce the company's unsecured debt while increasing value for stockholders. Dynegy's plan, the examiner concluded, turned the "basic tenet[s] of corporate finance" upside down, including the notion that creditors be paid in full before stockholders can receive or retain value.

The examiner found that the power plants had been transferred to Dynegy in exchange for an illiquid, unsecured, highly unusual financial instrument called an "undertaking." Essentially, the "sale" to Dynegy of these power plants was, as per the examiner, no real sale at all. According to the examiner, the transaction "transferred hundreds of millions of dollars away from Dynegy's creditors in favor of its stockholders."

Because the transfer occurred prior to the bankruptcy filing, the examiner concluded that the transfer was an actual fraudulent transfer, and assuming that Dynegy Holdings was insolvent on the date of the transfer, he also concluded that it was a constructive fraudulent transfer that ultimately harmed Dynegy Holdings' creditors. Essentially, the transfer left Dynegy Holdings' creditors that were owed approximately $4 billion holding the proverbial bag.

Additionally, in his report the examiner suggested that certain directors tied to the transfer should not continue serving on the board, since any plan that would include the directors "would be inconsistent with the interests of creditors and public policy." The examiner found that the boards of Dynegy Holdings and Dynegy had crossover members, and he found that the corporate officers "did not understand the distinction, from a corporate and fiduciary prospective, between Dynegy Holdings and Dynegy Inc.," raising further the specter of alter ego.

In sum, the examiner found that the billion-dollar power plants should have been brought back into Dynegy Holdings' bankruptcy estate for the benefit of Dynegy Holdings' creditors.

Dynegy promptly filed a response to the examiner's report. In its response, Dynegy stated that the examiner's report was not evidence, was nonbinding and was not the conclusion of any court. Specifically, Dynegy claimed that the examiner improperly assumed insolvency, and that the evidence demonstrated that there was no intent to hinder or delay creditors, and overall, disagreed with all of the findings of the examiner.

A Bankruptcy War is Averted

Dynegy, of course, correctly noted that the examiner's findings were not binding. Nevertheless, the bomb had been dropped, and the reverberations began. Following the report, and the mismanagement allegations, rumblings immediately began for appointment of a bankruptcy trustee, which would have been akin to "going nuclear" for the Dynegy debtors and their boards. The appointment of the examiner and his findings were certainly a problem for the debtors, but appointment of a trustee would have presented an entirely different and more challenging situation for the debtors and, at some level, the future of Dynegy.

A Chapter 11 trustee supplants the debtor and its board of directors, taking control of the operations of the company, and the trustee, upon her decision to do so, would have been charged with pursuing the Section 548 fraudulent transfer claims investigated and compiled by the examiner. An examiner, in contrast, investigates and does not control the debtor. The appointment of the examiner over a bankruptcy trustee may have avoided a tipping point in the case, and ultimately allowed for a fairly quick resolution of the case.

The examiner's report laid out in detail a fraudulent transfer case, in addition to other potential claims, including alter ego and breach of fiduciary duty. Significantly, the leverage of the report ultimately lead to a successful mediation, mediated by the examiner himself.

On April 4, 2012, Dynegy announced it had reached a settlement that would, among other things, resolve all of the potential issues raised by the examiner in his report. Furthermore, Dynegy Holdings' unsecured creditors would receive common stock representing a 99 percent equity stake in the reorganized company. The settlement avoided the need to appoint a bankruptcy trustee, which was requested by the U.S. Trustee only days after the issuance of the examiner's report. The agreement averted the brewing fraudulent transfer war, and the parties could get down to the business of a confirmable plan.

On June 1, 2012, Judge Morris approved Dynegy's settlement agreement with its creditors. The agreement resolved more than $2.7 billion in claims of Dynegy Holdings. Pursuant to the terms of the agreement, all disputes, claims and causes of action between Dynegy Holdings (i.e., as pursued by a trustee on behalf of the bankruptcy estate) and Dynegy were resolved. The debtors filed their third amended plan on June 8, 2012, incorporating the provisions of the agreement and ultimately, the court confirmed the plan in September.

The Upshot

The Dynegy bankruptcy case demonstrates how dangerous it might be for companies to engage in major asset restructuring right before a bankruptcy filing. The clever minds behind the Dynegy pre-bankruptcy restructuring plan may have been too clever in the end.

Certainly, the Dynegy debtors would have had their chance to argue that the movement of the power plant assets was not a fraudulent transfer, if those claims had been pursued. But if the bankruptcy had gone down that road, the end of the bankruptcy may never have been in sight, and Dynegy would have potentially taken a huge blow with the appointment of a bankruptcy trustee and with disruptions to plan confirmation arising from litigation concerning the movement of the assets, amongst other things.

The appointment of the examiner averted immediately going over that cliff in the case. The report avoided a quagmire of fraudulent transfer litigation, and the examiner, wearing his mediator hat, surely twisted arms on all sides with the threat of what was to come. Resolution swiftly followed, resulting in a confirmed plan of reorganization — the end goal for Dynegy, Dynegy Holdings, their shareholders and their creditors.

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