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Safe Harbor Defense Bars Creditors' State Law Fraudulent Transfer Claims

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Creditors of a Chapter 11 debtor asserting "state law, constructive fraudulent [transfer] claims … are preempted by Bankruptcy Code Section 546(e)," held the U.S. Court of Appeals for the Second Circuit on March 29, 2016. *In re Tribune Company Fraudulent Conveyance Litigation*, 2016 WL 1226871, *1 (2d Cir. Mar. 29, 2016) (as corrected). Section 546(e), the so-called "safe harbor" defense, "shields from avoidance proceedings brought by a bankruptcy trustee transfers by or to financial intermediaries effectuating settlement payments in securities transactions or made in connection with a securities contract, except through an intentional fraudulent [transfer] claim." *Id.*

Affirming the district court's dismissal of the creditors' suit, the Second Circuit rejected the district court's analysis, relying instead on a preemption analysis. In a separate summary unpublished order, the court affirmed another district court decision dismissing a similar suit on preemption grounds "for substantially [the same] reasons." *Whyte v. Barclays Bank PLC*, No. 13-2653-CV (March 24, 2016).

The court in *Tribune* explicitly rejected the district court's holding that Section 546(e) bars only a bankruptcy trustee from avoiding a settlement payment (*i.e.*, Congress never intended to prohibit individual creditors from avoiding settlement payments under state law). *In re Tribune Company Fraudulent Conveyance Litigation*, 499 B.R. 310, 318-320 (S.D.N.Y. 2013). The debtor in *Tribune* had transferred "over $8 billion to a 'securities clearing agency' [and another] 'financial institution,'… [that acted] as intermediaries in [a leveraged buyout (LBO)] transaction," but the plaintiff creditors sued only the shareholders who ultimately received the funds, *not* the intermediaries. 2016 WL 1138723, at *1.

Relevance

Lower courts had been split as to whether the Bankruptcy Code (Code) preempted individual creditors from prosecuting state law claims in the context of a bankruptcy case. *See, e.g., In re Lyondell Chem. Co.*, 503 B.R. 348, 372-73 (Bankr. S.D.N.Y. 2014), *as corrected* (Jan. 16, 2014) (Section 546(e) does *not* protect "LBO payments to stockholders [when they] are the ultimate beneficiaries … and can give the money back to injured creditors … ."). *Contra*, *Whyte v. Barclays Bank PLC* (*In re SemCrude, L.P.*), 494 B.R. 196, 201 (S.D.N.Y. 2013) (Code's safe harbor defense "impliedly preempts state-law fraudulent" transfer suits).

Imaginative lawyers have diligently tried to work around the Second Circuit's two recent decisions broadly reading Section 546(e). *See Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329, 339 (2d Cir. 2011); and *In re Quebecor World (USA) Inc.*, 719 F.3d 94 (2d Cir. 2013). These lawyers have asked creditors to assign their claims to the trustee, *Whyte*, *supra*, or argued that individual creditors could sue on their own. *Tribune*, *supra*.

The Second Circuit's *Tribune* and *Whyte* decisions resolve the preemption issue. As shown herein, the court also responded to commentators who complained

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about the negative financial impact on debtors' estates caused by decisions broadly construing the Code's safe harbor defense. *See, e.g.,* Pinkas & Pisciotta, "To Boldly Go Where No Court Has Gone Before: Enron and the Application of § 546(e)," *ABI Journal*, Oct. 2011 (" … Since [Enron] was rendered, lender recoveries and unsecured creditor distributions will be diminished by literally billions of dollars."); J. Stepanian, "Will Bankruptcy Preference Decision [Enron] 'Imperil Decades of Cases'?" *Litigation News*, Fall 2011. *But see* Mark D. Sherrill, "In Defense of the Bankruptcy Code's Safe Harbors," 70 *Bus. Lawyer* 1007, 1008 (2015) (Academics and some legislators imply "that the safe harbors represent some misbegotten benefit gifted from Congress to a powerful special-interest group … [But] they reflect a policy judgment on the part of Congress that favors a safeguard against systemic risk over … policies of…rehabilitation and maximizing creditor recovery.").

Facts

Unsecured creditors sued the debtor's shareholders asserting "state law, constructive fraudulent [transfer] claims … ." 2016 WL 1226871, at *2. Essentially, they asserted that the debtor made cash transfers "for less than reasonably equivalent value when the debtor was insolvent or was rendered so by the transfer." Because the creditors' committee in the pending Chapter 11 case had not brought these claims within the Code's two-year statute of limitations, the creditors argued that the state law claims had "reverted to individual creditors." *Id*.

The bankruptcy court allowed the creditors to sue, but stressed that it was not "resolving the issues of whether the individual creditors had statutory standing to bring such claims or whether such claims were preempted by Section 546(e)." *Id*. at *3. Under the debtor's judicially confirmed reorganization plan, the individual creditors were permitted to pursue "any and all LBO-related Causes of Action arising under state fraudulent conveyance law," except for any federal intentional fraudulent transfer claims and other related claims being pursued by a Litigation Trust authorized to pursue those claims. *Id*.

The district court consolidated the individual creditors' claims with those asserted by the Litigation Trust. "It later dismissed their claims, reasoning that the…Code's automatic stay…deprived [the creditors] of statutory standing to pursue their claims so long as the Litigation Trustee was pursuing the avoidance of the same transfers … ." *Id*. Rejecting the defendant shareholders' preemption argument under Section 546(e), the district court held that the section "applied only to a bankruptcy trustee … and [that] … Congress had declined to extend Section 546(e) to state law, fraudulent conveyance claims brought by creditors." *Id*. at *4.

The Second Circuit

Preemption

The court easily found that the bankruptcy court's orders and the confirmed reorganization plan permitted the creditors to assert "actionable state law, constructive fraudulent conveyance claims." *Id*. at 5. More important, however, the court held that the creditors' claims were "preempted because they conflict with … Section 546(e)." *Id*. Despite the language of the section "limiting avoidance by a trustee," but "not creditors acting on their behalf," preemption was, in the court's view, still possible. First, "detailed, preemptive federal regulation of creditors' rights has … existed for over two centuries," and the "Bankruptcy Code constitutes a wholesale preemption of state laws regarding creditors' rights." *Id*. at *7.

Indeed, explained the court, the creditors' "state law claims were preempted when the Chapter 11 [case] commenced … ." *Id*. *See Arizona v. U.S.*, 132 S. Ct. 2492, 2501 (2012) ("First, the States are precluded from regulating the conduct in a field that Congress … has determined must be regulated by its exclusive governance … . The intent to displace state law altogether can be inferred from a framework of regulation 'so pervasive … that Congress left no room for the States to supplement it' or where there is a 'federal interest … so dominant that the federal system will be assumed to preclude enforcement of state laws on the same subject.'") quoting *Rice v. Santa Fe Elevator Corp*., 331 U.S. 218, 230 (1947).

Once the debtor "entered bankruptcy, the creditors' avoidance claims were vested in the federally appointed trustee … ." 2016 WL 1226871, at *7. Any constructive fraudulent transfer claim, assertable by a trustee under the Code, "is a claim arising under federal law." Finally, disposition of these claims has "everything to do with the …

Bankruptcy Code's balancing of debtors' and creditors' rights, … or rights among creditors, … and nothing to do with the vindication of state police powers." *Id*. Moreover, said the court, "the policies reflected in Section 546(e) relate to securities markets which are subject to extensive federal regulation … . [T]here is no measurable concern about federal intrusion into traditional state domains." *Id*. at *8.

The Language of Section 546(e)

Section 544(b) enables a trustee to "avoid a transfer … [by] the debtor … voidable under applicable law by a[n] [unsecured] creditor," but Section 546(e) "expressly prohibits trustees … from using [these] avoidance powers … against the transfers specified in [that section]." *Id*. Thus, "Section 546(e) covers all transfers by or to financial intermediaries that are 'settlement payment[s]' or 'in connection with a securities contract.' Transfers in which either the transferor or transferee is not such an intermediary are clearly included in [Section 546(e)]. So long as the transfer sought to be avoided is within the language [of Section 546(e)], the Section includes avoidance proceedings in which the intermediary would escape a … judgment." *Id*.

No Automatic Reversion Of Claims to Creditors

The court rejected the creditors' argument that the claims "automatically" reverted to them after the applicable statute of limitations had expired "or by the bankruptcy court's lifting of the stay … ." *Id*. at *9-*10. First, reasoned the court, the Code does not support the creditors' argument. "Section 544's statute of limitations … says nothing about the reversion of claims vested in the trustee … by Section 544." *Id*. at *11.

Because a statute of limitations is "intended to limit the assertion of stale claims and to provide peace to possible defendants … , and not to change the identity of the authorized plaintiffs without some express language to that effect," the creditors' argument failed. *Id*. Also, because Section 546(e) permits a trustee to bring an intentionally fraudulent transfer claim, it would be anomalous, reasoned the court, to allow the trustee to bring these claims "while not extinguishing constructive fraud claims but rather leaving them to be brought later by individual creditors. In particular, enforcement of the intentional fraud claim [by the trustee] is undermined if creditors can later bring state law, constructive fraudulent [transfer] claims involving the same transfers. Any trustee would have grave difficulty negotiating more than a nominal settlement in the federal action if it cannot preclude state claims attacking the same transfers …. As happened [here], … the trustee's … action awaits the pursuit of piecemeal actions by creditors … [,] precisely [contrary to] the intent of the Code's procedures." *Id*. *See In re PWS Holding Corp.*, 303 F. 3d 308 (3d Cir. 2002) (individual creditor enjoined from bringing state law fraudulent transfer action after confirmation of plan; creditor's right to bring suit had been extinguished by confirmation order; creditor objected, and failed to appeal; court's enjoining of post-confirmation suit and sanction against individual creditor affirmed).

Effect on Securities Markets

Finally, the court rejected the creditors' argument, based on their "imagined" view of the securities markets, that Section 546(e) limits only the trustee's avoidance powers, but permits actions by individual creditors. *Id*. at *12. The creditors argued that "actions by trustees … are a greater threat to securities markets than are actions by individual creditors," but, said the court, this "argument lacks any support whatsoever in the legislative deliberations that led to Section 546(e)'s enactment." "Moreover," added the court, "[the creditors'] arguments understate the number of creditors who would sue, if allowed, and the corresponding extent of the danger to securities markets." *Id*. *See Grede v. FC Stone, LLC*, 746 F. 3d 244, 253-54 (7th Cir. 2014) (" … Congress chose finality over equity for most pre-petition transfers in the securities industry — *i.e.*, those not involving actual fraud. In other words, § 546(e) reflects a policy judgment by Congress that allowing some otherwise avoidable prepetition transfers in the securities industry to stand would probably be a lesser evil than the uncertainty and potential lack of liquidity that would be caused by putting every recipient of [pre-bankruptcy] settlement payments … at risk of having its transactions unwound in the bankruptcy court.").

Effect on Creditor Recoveries

The court rejected the creditors' argument that its reading of Section 546(e) would undermine "the goal of maximizing the assets available to creditors." *Id*. According to the court, the purpose of the Section

is "to protect a national, heavily regulated market by limiting creditors' rights … . Section 546(e) cannot be trumped by the Code's goal of maximizing the return to creditors without thwarting the Section's purposes." *Id*. at *19.

Whyte v. Barclays Bank PLC

The Second Circuit, in an accompanying unpublished summary order, affirmed a district court's holding that the Code "section 546(g) 'safe harbor' impliedly preempts state-law fraudulent conveyance actions seeking to avoid 'swap transactions' as defined by the Code." *Whyte v. Barclays Bank PLC*, 494 B.R. 196, 201 (S.D.N.Y. 2013). The court affirmed "for substantially the reasons stated in" the *Tribune* opinion. In *Whyte*, the district court rejected a trustee's "clever" assignment of state law fraudulent transfer claims to avoid the Code's "swap agreement" safe harbor contained in Section 546(g). Like Section 546(e), Section 546(g) insulates pre-bankruptcy transfers "made by or to … a swap participant … under or in connection with any swap agreement." *Id*. at 199.

Five weeks prior to bankruptcy, the defendant bank in Whyte had acquired the debtor's "portfolio of commodities derivatives traded on the New York Mercantile Exchange" for roughly $143 million. That portfolio later became profitable, apparently causing creditors to assert that the transaction was a fraudulent transfer under applicable state law. *Id*. at 198. Although the debtor's Chapter 11 plan documents provided that "certain creditors … and the relevant debtors … putatively assigned 'any and all' of their claims, [including fraudulent transfer claims] to the [litigation] trust," the district court relied on implied preemption to dismiss the complaint. According to the district court, the trustee's "clever" attempt to rely on her state law rights as an "assignee," but not as the "trustee of the bankruptcy estate … would, in effect, render section 546(g) a nullity." *Id*. at 199.

Comment

Tribune and *Whyte* are consistent with the broad reading of the Code's safe harbor defense by appellate courts. *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329, 339 (2d Cir. 2011) (trustee barred from recovering settlement payments for debtor's early redemption of publicly traded commercial paper); *In re Quebecor World (USA) Inc.*, 719 F.3d 94 (2d Cir. 2013) (debtor's payments to redeem private placement notes insulated from preference attack by Sections 546(e)); *In re QSI Holdings*, 571 F.3d 545, 550 (6th Cir. 2009) (same); *In re Bevill, Bresler & Schulman Asset Mgmt Corp.*, 898 F.2d 742, 751-52 (3d Cir. 1989) (same); *In re Kaiser Steel Corp.*, 952 F.2d 1230, 1237-40 (10th Cir. 1991); *In re Comark*, 971 F.2d 322, 326 (9th Cir. 1992); *In re Resorts Int'l. Inc.*, 181 F.3d 505, 514-16 (3d Cir. 1999) (payments to shareholders in LBO are settlement payments for purposes of Section 546(e)); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 987 (8th Cir. 2009) (payments to selling shareholders in LBO insulated by Section 546(e)).

The appellate courts' broad reading of the safe harbor provisions still has limits. "Of course, the 'securities contract' safe harbor is not without limitation, and, for example, mere structuring of a transfer as a 'securities transaction' may not be sufficient to preclude avoidance." *Quebecor*, 719 F. 3d at 100 n.4, citing Code § 546(e), § 548(a)(1)(A) (transfer made "with actual intend to hinder delay or defraud" creditors expressly excluded from § 546(e) safe harbor protection). This explicit statutory limitation was also stressed by the Fourth Circuit. " … Section 546(e) … provide[s] several express exceptions … including [a transfer made with actual fraudulent intent]. "*In re Derivium Capital LLC*, 716 F.3d 355, 366 (4th Cir. 2013). Indeed, courts have regularly held that the "existence of a Ponzi scheme [gives] rise to a presumption of actual fraud on the part of the broker, triggering the fraud exception to the stockbroker defense." *Id*., citing *In re Manhattan Investment Fund Limited*, 397 B.R.1, 14n. 18 (S.D.N.Y. 2007), aff'd 328 F. App'x 709 (2d Cir. 2009). *See also Peterson v. Somers Dublin Ltd*., 729 F. 3d 741, 749 (7th Cir. 2013) ("The presence of an exception for actual fraud makes sense only if § 546(e) applies as far as its language goes.").

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