Bankruptcy ADVISORY

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SDNY Bankruptcy Court Holds That the Bankruptcy Safe Harbors Do Not Preclude State-Law Fraudulent Transfer Actions Brought by Creditors

A bankruptcy judge in the Southern District of New York recently held that section 546(e) of the Bankruptcy Code does not prevent a debtor's creditors from bringing state-law fraudulent conveyance actions that challenge a leveraged buyout of the debtor. ***Weisfelner v. Fund 1*** (***In re Lyondell Chem. Co.***), No. 10-4609 (REG), --- B.R. ----, 2014 WL 118036 (Bankr. S.D.N.Y. Jan. 14, 2014).

This opinion expressly adopts the reasoning found in ***In re Tribune Co. Fraudulent Conveyance Litig***., 499 B.R. 310 (S.D.N.Y. 2013). It expressly rejects the reasoning of ***Whyte v. Barclays Bank PLC***, 494 B.R. 196 (S.D.N.Y. 2013).

Background

In December 2007, Basell AF S.C.A. acquired Lyondell Chemical Company through a leveraged buy-out (LBO). The LBO was financed entirely by debt, which was secured by all of Lyondell's assets. Approximately $12.5 billion of the approximately $21 billion in debt taken on by Lyondell was distributed to Lyondell's shareholders.

Just over one year later, Lyondell filed a petition for relief under Chapter 11 of the Bankruptcy Code. In Lyondell's bankruptcy case, Lyondell eventually confirmed a plan of reorganization that provided, among other things, for (i) the creation of a litigation trust (the "Creditor Trust") to which certain causes of action that had belonged to the debtor's estate would be abandoned and (ii) the assignment by creditors of their state-law claims to the Creditor Trust. Of particular importance, one class of causes of action that were given to the Creditor Trust were state-law fraudulent transfer actions (e.g., claims based on nonbankruptcy state law that prohibit transfers made for less than reasonably equivalent value at a time when the debtor was in a distressed financial condition or put into a distressed financial condition as a result of the transfer). After confirmation of the plan, and the conveyance of the state-law fraudulent transfer causes of action to the Creditor Trust, the Creditor Trust commenced an action asserting the state-law fraudulent transfer actions against certain of the Lyondell shareholders who had received the proceeds of the LBO.

The defendants sought dismissal of the action on several grounds, including in relevant part that (a) the claims were preempted by the Bankruptcy Code and (b) nevertheless, the state-law fraudulent transfer claims were barred by section 546(e) of the Bankruptcy Code (the "Safe Harbor"). Specifically, the defendants asserted that the Safe Harbor, which precludes a trustee or a debtor from avoiding a fraudulent transfer based on certain provisions of the Bankruptcy Code to the extent the transfer constitutes, among other things, a settlement payment or margin payment, also applies to state-law fraudulent transfer claims that are available to and are asserted by creditors.

The Decision

The bankruptcy court denied the defendants' motion, finding that (a) section 546(e) did not bar the Creditor Trust from bringing a state-law fraudulent transfer claim and (b) these state-law claims were not preempted by the Bankruptcy Code.

Section 546(e) provides in relevant part that "the trustee may not avoid a transfer that is a margin payment . . . or settlement payment . . . 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, . . . commodity contract, . . . or forward contract, that is made before the commencement of the case, except" in cases of actual fraud.

Quoting the ***Tribune*** court, the ***Lyondell*** court found that "Congress did not make section 546(e) applicable to claims by or on behalf of individual creditors. . . . [I]f Congress intended section 546(e) to be more broadly applicable, 'it could simply have said so.'" Accordingly, since the Creditor Trust was bringing only claims on behalf of individual creditors and not on behalf of the debtor and/or its estate, the court found that section 546(e) did not act to bar the action.

Similarly, the ***Lyondell*** court examined the plain language of section 546(e) to find that it did not expressly preempt state-law fraudulent conveyance claims. (In fact, the defendants did not even contend that there was express preemption, but the bankruptcy court examined such an argument nonetheless.)

The court also rejected the argument that the Bankruptcy Code preempted state-law fraudulent conveyance actions through "field preemption," which "occurs when Congress has manifested an intent to 'occupy the field' in a certain area, as evidenced by 'a scheme of federal regulation so pervasive as to make reasonable inference that Congress left no room for the States to supplement it, or where an Act of Congress touches a field in which the federal interest is so dominant that the federal system will be assumed to preclude enforcement of state laws on the same subject." Rather, the court found that state-law fraudulent transfer actions actually pre-dated the Bankruptcy Code (going back to the time of the Revolutionary War) and that state and federal fraudulent transfer laws coexisted. Indeed, section 544 of the Bankruptcy Code expressly allows bankruptcy trustees to bring state-law fraudulent transfer actions. Accordingly, the court found that there was no federal field preemption of fraudulent transfer actions.

Finally, the court rejected the defendants' argument that section 546(e) preempted state-law fraudulent conveyance actions through so-called "conflict preemption." In essence, the defendants argued that the congressional policy underlying the enactment of section 546(e) would be undermined by allowing the state-law fraudulent transfer action to continue, and this conflict can only be resolved by finding that federal law barred the state-law action. Again relying on the rationale in ***Tribune***, the ***Lyondell*** court found that, while section 546(e) was enacted in part to "protect the nation's financial markets from the instability caused by the reversal of settled securities transactions," section 546(e) was not enacted "to protect market stability to the exclusion of all other policies." The court noted that "even after having been asked to do so, Congress failed to expressly preempt state law constructive fraudulent transfer claims." Moreover, "'Congress chose not to extend Section 546(e) to [state law constructive fraudulent transfer] claims filed *before* bankruptcy or to intentional fraudulent conveyance claims brought *after* a bankruptcy filing, even though these types of claims pose the very same threat to the stability of securities markets.'" In addition, the court noted that, in 1998, Congress "expressly preempted state fraudulent transfer laws that would permit individual creditors to recover with respect to such contributions so long as the contributions did not exceed the Congressionally prescribed amount. But Congress enacted no similar provision to preempt state fraudulent transfer laws in other respects, before then or thereafter." Accordingly, the court reasoned that Congress had not intended to preempt the state-law fraudulent transfer action at issue in ***Lyondell***.

In reaching this conclusion, the court distinguished and disagreed with the rationale in ***Barclays***. In ***Barclays***, a district court found that a litigation trust established under a bankruptcy plan could not bring state-law constructive fraudulent conveyance actions with respect to the prepetition novation of a swap portfolio. The ***Lyondell*** court distinguished this case by noting that the ***Barclays*** litigation trust was simultaneously bringing actions both on behalf of creditors and on behalf of the debtors and their estates. Since a bankruptcy trustee could not avoid the operation of section 546(e) simply by stating that it was bringing actions on behalf of creditors, the litigation trust could not effectively do the same thing when it was acting as a representative of the bankruptcy estate. However, in ***Lyondell***, the Creditor Trust was not bringing any actions on behalf of an estate or a debtor; the Creditor Trust was acting solely on behalf of creditors as a result of the estate's abandonment of its claims and the creditors' assignment of theirs. In addition, for all of the reasons stated above, the ***Lyondell*** court disagreed with the ***Barclays*** court's preemption reasoning.

Conclusion

With the ***Lyondell*** decision, the Bankruptcy Court for the Southern District of New York has concluded that, while the Safe Harbor may protect recipients of an alleged fraudulent conveyance from claims brought by a debtor/trustee that are based on provisions of the Bankruptcy Code, the Safe Harbor may not protect the transferee from fraudulent transfer claims (such as settlement payments and margin payments that are made prior to bankruptcy) that are (i) based on nonbankruptcy state law **and** (ii) brought by creditors. Nevertheless, the final chapter on these issues may not be fully written as the Second Circuit has been asked to address the preemption issues in ***Tribune.***

***This advisory was written by* David Wender, Aimee Cummo, Karen Gelernt *and* John Spears.**

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