Second Circuit Holds Bankruptcy Code Safe Harbors Bar State Law Fraudulent Conveyance Claims Brought By Individual Creditors

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This article explains two recent U.S. Court of Appeals for the Second Circuit decisions that are relevant to investors and others engaged in structuring transactions for which safe harbor protection may be contemplated.

In March 2016, the U.S. Court of Appeals for the Second Circuit issued an opinion concluding that the "safe harbor" provision of the Bankruptcy Code for settlement payments and payments in connection with a securities contract bars fraudulent conveyance claims brought not only by a bankruptcy "trustee" (as stated in Section 546(e) of the Code), but also by creditors seeking to assert state law claims that Section 544 of the Code empowers a bankruptcy trustee to bring.[1] In a separate summary order, the court also reached a similar non-precedential ruling with respect to the Section 546(g) safe harbor applicable to swap transactions.[2]

The Second Circuit Decisions are significant for at least three reasons: *first*, they further clarify and confirm the expansive scope of the Section 546(e) securities safe harbor; *second*, they reaffirm that the Section 546(e) securities safe harbor applies to protect shareholder payments in the context of leveraged buy-out ("LBO") transactions just as it does with respect to other types of securities transactions; and, *third*, they raise but leave for another day the question of whether creditors may bring state law fraudulent conveyance claims that are vested in a bankruptcy trustee by Section 544 of the Code if such claims are not barred by the securities safe harbor defense. The Second Circuit Decisions are particularly relevant to investors and others engaged in structuring transactions for which safe harbor protection may be contemplated.

Background and Procedural History

The Second Circuit Decisions resolved appeals from two Southern District of New York decisions addressing the scope of the safe

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harbors under Section 546 of the Bankruptcy Code.

Whyte v. Barclays Bank PLC

In *Whyte v. Barclays Bank PLC*,[3] the district court considered the power of the trustee of a litigation trust established pursuant to a Chapter 11 reorganization plan (the "Litigation Trustee") to pursue state law causes of action that individual creditors (the "SemGroup Individual Creditors") had transferred to the litigation trust. Relying on claims assigned by the SemGroup Individual Creditors to that trust, the Litigation Trustee sought to bring a claim under New York's Debtor & Creditor Law against Barclays and others to unwind a transfer of SemGroup's NYMEX portfolio, asserting that the transfer constituted a fraudulent conveyance. In response, the defendants invoked the safe harbor provision codified in Section 546(g) of the Bankruptcy Code, which generally prevents avoidance and recovery of transfers to or from swap participants or financial participants.[4] The Litigation Trustee, in turn, argued that because Section 546(g) applies by its terms only to a "trustee" who is "exercising federal avoidance powers under [Section 544 of] the Bankruptcy Code," the swap securities safe harbor defense should not apply to creditor claims brought under state law after the bankruptcy concludes without releasing such claims.[5]

District Court Judge Jed Rakoff rejected the Litigation Trustee's argument, holding that the Section 546(g) swap safe harbor applied to the Litigation Trustee, and impliedly preempted the state law causes of action she sought to pursue, because permitting such claims to proceed would frustrate the objective of Congress to protect such types of transfers from avoidance and recovery.[6] The court reasoned that to hold otherwise would render Section 546 a nullity by allowing a trustee or creditors to avoid the safe harbors by "the simple devise of conveying fraudulent conveyance claims into a litigation trust for later use, repackaged as creditors' state law fraudulent conveyance claims," rather than pursuing such claims under the powers established by Section 544 of the Code.[7]

In re Tribune Company Fraudulent Conveyance Litigation

In *In re Tribune Company Fraudulent Conveyance Litig.*,[8] the same district court reached a potentially conflicting result on a similar issue. The case involved the bankruptcy of the Tribune Company ("Tribune"), filed following a 2007 LBO. Relevant here, the Official Committee of Unsecured Creditors filed a complaint against cashed-out Tribune shareholders, Tribune's officers and directors, as well as others that benefited from the buyout, asserting the debtor's actual fraudulent conveyance claims pursuant to Section 548(a)(1)(A) of the Code.[9] The Official Committee of Unsecured Creditors chose not to include federal constructive fraudulent conveyance claims under Section 548(a)(1)(B) out of a concern that the LBO transaction likely fell within the transactions covered by the Section 546(e) securities safe harbor defense.[10] After the bankruptcy court lifted the automatic stay on claims by Tribune creditors, however, various individual creditors (the "Tribune Individual Creditors") filed separate actions in a variety of state and federal courts, attempting to unwind the LBO transfers or recover monetary damages based on state law constructive fraudulent conveyance theories. These cases were consolidated before District Court Judge Richard J. Sullivan

in the Southern District of New York. The defendants argued that the claims asserted by the Tribune Individual Creditors failed for two reasons: first, that although Section 546(e) on its face only precludes claims by a "trustee," its protection also extends to those claims that the trustee in bankruptcy *could* pursue and, second, that the Tribune Individual Creditors lacked standing to pursue fraudulent conveyance claims outside of bankruptcy while the Official Committee of Unsecured Creditors simultaneously pursued fraudulent conveyance claims in the bankruptcy proceedings.

Addressing each question in turn, Judge Sullivan first held that Section 546(e) did *not* preempt the Tribune Individual Creditors' state law claims, distinguishing the claims asserted by the Tribune Individual Creditors in the case before him from the trustee's asserted claims in *Whyte* by explaining that:

> In essence, [the litigation trustee in *Whyte*] could not simply take off its trustee hat, put on its creditor hat, and file an avoidance claim that Section 546(g) prohibited the trustee from filing. By contrast, the [Tribune] Individual Creditors here, unlike [in *Whyte*], 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 [in *Whyte*].[11]

Turning to the second issue, however, the court dismissed the Tribune Individual Creditors' claims on the grounds that the Tribune Individual Creditors had no standing to pursue the suit as long as the Creditors' Committee was attempting to unwind the same transaction.[12]

Due to the related and overlapping issues, the Court of Appeals for the Second Circuit heard oral arguments for *Whyte* and *In re Tribune Co.* together on appeal.

The Tribune Opinion

The Second Circuit affirmed the dismissal of the Tribune Individual Creditors' state law constructive fraudulent conveyance claims in a published decision. While the lower court had dismissed the claims on the basis of standing, the Second Circuit held that it was the Section 546(e) securities safe harbors that prevented the Tribune Individual Creditors' state law constructive fraudulent transfer claims from proceeding.

With respect to the grounds relied upon by the district court, the Second Circuit held that, once the automatic stay under the Bankruptcy Code was lifted under the debtors' plan of reorganization and various other court orders, the automatic stay no longer barred the Tribune Individual Creditors from pursuing individual claims outside of bankruptcy that sought relief similar to or overlapping with the relief sought in the bankruptcy proceedings.[13] The court particularly noted the provisions of Tribune's plan of reorganization, which expressly allowed the Tribune Individual Creditors to pursue "any and all LBO-Related Causes of Action arising under state fraudulent conveyance law," and provided that "nothing in this Plan shall or is intended to impair" the rights of the Tribune Individual Creditors to pursue such claims.[14]

The Second Circuit also held that it was wrong to characterize the application of Section 546(e) in this case as one of "preemption." As the court reasoned, in light of federal bankruptcy jurisdiction, "[a]ppellants' state law claims were preempted when the Chapter 11 proceedings commenced and were not dismissed."[15] Rather, the court explained, the question was whether the Tribune Individual

Creditors' state law claims were restored (in whole or in part) either by expiration of the two-year bankruptcy statute of limitations for a debtor to bring such claims or by order of the court.[16] Because federal law governed both the existence and possible preclusion of the claims at issue, the Second Circuit proceeded to consider whether Section 546(e) applied as a matter "of inferring congressional intent from the [Bankruptcy] Code, without significant countervailing pressures" to apply a presumption against preemption.[17]

The court next conducted an expansive analysis of whether the Section 546(e) securities safe harbor barred the Tribune Individual Creditors' state law claims, notwithstanding that those claims were not asserted by a "trustee," the party barred from pursuing such claims by the terms of Section 546(e). With respect to that issue, the Tribune Individual Creditors argued that, although their state law claims were stayed by the filing of Chapter 11 proceedings, once the bankruptcy trustee failed to assert those claims pursuant to Section 544 of the Code, they became ripe for creditors to assert themselves. The defendants argued that such a rule would make little sense for state law claims like the ones at hand, where the bankruptcy trustee was *precluded* by Section 546(e) from asserting such claims, and that permitting individual creditors to assert such claims would amount to a blatant end-run around the Bankruptcy Code safe harbor protections.

The court rejected the Tribune Individual Creditors' theory, finding that Section 546(e) did bar their claims. The first step in the court's analysis was to consider whether the Tribune Individual Creditors' claims had "reverted" to them in full (*i.e.*, unimpeded by Section 546(e)) after they were not pursued by the Official Committee of Unsecured Creditors, exercising the power of a trustee in bankruptcy. The court expressed skepticism on this point, finding no support in the Bankruptcy Code for the proposition that creditors can themselves assert claims outside of bankruptcy merely because those claims were not asserted by the bankruptcy trustee. As the Second Circuit reasoned, the Bankruptcy Code itself merely prescribes a two-year limitations period for a trustee to assert claims, but does not in any way state or imply that claims not asserted by a bankruptcy trustee within that period revert to creditors who might have asserted them outside of the bankruptcy context.[18] The Second Circuit further noted that such a rule would make little sense because it would overly complicate bankruptcy proceedings. Allowing individual creditors to bring claims that the securities safe harbors would bar the debtor from bringing would both potentially require defendants to face potential fraudulent conveyance claims in multiple forums brought by multiple plaintiffs, and frustrate the debtor's ability to settle other fraudulent conveyance claims brought against the same defendants since the state law claims of individual creditors would not be released.[19] While it expressed doubt that such state law creditor claims "revert" to creditors when a bankruptcy trustee fails to pursue them under Section 544 of the Code, the Second Circuit expressly declined to resolve the appeal on those grounds.[20]

Rather, the court went on to resolve the case by interpreting Section 546(e) itself, considering whether "a consensus would have existed among reasonable, contemporaneous readers" at the time that the safe harbor was enacted that it barred only claims brought by a

"trustee." Concluding that no such consensus would have existed, the Second Circuit turned to the legislative history and context underlying Section 546(e) to consider whether it impairs creditors' right to bring state law fraudulent conveyance claims following a Chapter 11 filing. With the understanding that the safe harbors exist to protect the securities transactions from being unwound long after completion, the Second Circuit explained that "[u]nwinding settled securities transactions by claims such as [the Tribune Individual Creditors'] would seriously undermine—a substantial understatement—markets in which certainty, speed, finality, and stability are necessary to attract capital. To allow [the Tribune Individual Creditors'] claims to proceed, we would have to construe Section 546(e) as achieving the opposite of what it was intended to achieve."[21] In ultimately finding that Congress intended to preempt state law fraudulent conveyance claims brought by individual creditors, the Second Circuit stated definitively that a legal theory which would allow the Tribune Individual Creditors' claims to proceed "hangs on the ambiguous use of the word 'trustee,' has no basis in the language of the [Bankruptcy] Code, leads to substantial anomalies, ambiguities and conflicts with the [Bankruptcy] Code's procedures, and, most importantly, is in irreconcilable conflict with the purposes of Section 546(e)."[22]

Separately, and somewhat in passing, the Second Circuit also affirmed the applicability of the Section 546(e) safe harbors to LBO transactions such as the one that gave rise to the Tribune Opinion, though it did note that the Bankruptcy Court for the Southern District of New York recently expressed a contrary view.[23]

The Whyte Summary Order

The Whyte Summary Order affirmed the dismissal of the claims in that case for "substantially the reasons" stated in the Tribune Opinion. Notably, *Whyte* concerned a slightly different safe harbor provision—the swap safe harbor contained in Section 546(g) of the Code, as opposed to the Section 546(e) securities safe harbor. Although summary orders lack precedential effect, it appears to be relatively clear that the Second Circuit views the analysis to be the same under either provision of the Code.

Significance of *Tribune/Whyte*

The Tribune Opinion is significant as the first appellate decision to consider, and reject, the strategy of filing individual creditor constructive fraudulent conveyance claims after a plan of reorganization has been confirmed in order to avoid application of bankruptcy safe harbors to leveraged buy-out transactions and other complex financial transactions. The decision resolves the different results reached by the district courts in *Tribune* and *Whyte*, as well as a decision issued by the Bankruptcy Court for the Southern District of New York in the Lyondell bankruptcy that held that Section 546(e) did not preempt state law constructive fraudulent conveyance claims brought by individual creditors.[24] The Second Circuit left for another day the question of whether individual creditors could bring unasserted state law fraudulent conveyance claims that were not barred by the Bankruptcy Code safe harbor provisions.

More generally, the Second Circuit Decisions further affirm the robust protections provided by the safe harbor provisions in Sec-

tion 546 of the Bankruptcy Code against the avoidance and recovery claims that otherwise may be pursued in a bankruptcy. This continues a trend of decisions over the last few years in the Second Circuit that has reinforced the strength of the safe harbors, and provides further guidance to parties seeking to rely on the safe harbor provisions in structuring their financial dealings.

NOTES:

[1]*In re Tribune Co. Fraudulent Conveyance Litigation*, 818 F.3d 98 (2d Cir. 2016) ("*Tribune II*," or as referenced in the text, the "Tribune Opinion").

[2]*Whyte v. Barclays Bank PLC*, 644 Fed. Appx. 60 (2d Cir. 2016) ("*Whyte II*," or as reference in the text, the "Whyte Summary Order," and together with the Tribune Opinion, the "Second Circuit Decisions"). While both the Second Circuit Decisions are important and involve similar issues, only the Tribune Opinion will have precedential value, since summary orders do not have precedential effect.

[3]*Whyte v. Barclays Bank PLC*, 494 B.R. 196 (S.D.N.Y. 2013) ("*Whyte I*").

[4]Section 546(g) of the Bankruptcy Code states that "notwithstanding sections 544, 545, 547, 548(a)(1)(B) and 548(b) of this title, the trustee may not avoid a transfer, made by or to (or for the benefit of) a swap participant or financial participant, under or in connection with any swap agreement and that is made before the commencement of the case, except under section 548(a)(1)(A) of this title." 11 U.S.C.A. § 546.

[5]*Whyte I*, 494 B.R. at 199 (internal quotations omitted).

[6]*Id.* at 200 (internal citations and quotations omitted).

[7]*Id.* at 201 (internal citations omitted).

[8]*In re Tribune Co. Fraudulent Conveyance Litig.*, 499 B.R. 310 (S.D.N.Y. 2013) ("*Tribune I*").

[9]*Id.* at 313–14.

[10]Section 546(e) states that "[n]otwithstanding 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." *Tribune I*, 499 B.R. at 313–14.

[11]*Id.* at 319.

[12]*Id.* at 325 ("Unless and until the [Creditors'] Committee actually and completely abandons those claims, the [Tribune] Individual Creditors lack standing to bring their own fraudulent conveyance claims targeting the very same transactions.").

[13]*Tribune II*, 818 F.3d at 115.

[14]*Id.* at 109 (internal citations and quotations omitted).

[15]*Id.* at 111.

[16]*Id.*

[17]*Id.* at 112.

[18]*Id.* at 114.

[19]*Id.* at 114–15.

[20]*Id.* at 113–14.

[21]*Id.* at 119.

[22]*Id.* at 117, 119, 123.

[23]*See In re Lyondell Chemical Company*, 503 B.R. 348, 372–73 (Bankr. S.D.N.Y. 2014), *as corrected*, (Jan. 16, 2014). *Tribune II* at 122.

[24]*See In re Lyondell Chem. Co.*, 503 B.R. 348. It is worth noting, however, that subsequent to the Tribune Opinion, at least one lower court has disagreed with the Second Circuit's preemption holding. *See In re Physiotherapy Holdings, Inc.*, 62 Bankr. Ct. Dec. (CRR) 213, 2016 WL 3611831 (Bankr. D. Del. 2016). Additionally, the Litigation Trustee in *Whyte* has filed a petition for certiorari with the Supreme Court.