

January 17, 2014

clearygottlieb.com

Decision Adds To Debate Whether LBO Payments are Vulnerable to State Law Fraudulent Transfer Claims

On January 14, 2014, the U.S. Bankruptcy Court for the Southern District of New York held that the Bankruptcy Code's § 546(e) safe-harbor provision¹ neither protects against nor preempts state law constructive fraudulent transfer claims brought on behalf of individual creditors against cashed-out former shareholders of a company acquired in a leveraged buyout ("LBO"). By refusing to dismiss these claims, prosecuted by a creditor trust pursuant to a confirmed plan of reorganization, Bankruptcy Judge Robert E. Gerber's opinion in *Weisfelner v. Fund 1. (In re Lyondell Chemical Co.)*, Adv. Proc. Case No. 10-4609 (REG), 2014 WL 118036 (Bankr. S.D.N.Y. Jan. 14, 2014) (the "Opinion"), opens up the former shareholders who received distributions under a failed LBO to creditor fraudulent conveyance claims where the Bankruptcy Code § 546(e) safe harbors would preclude a debtor from pursuing such claims.

The Opinion

A. Facts & Procedural Background

In 2007, Basell AF S.C.A. ("Basell") acquired Lyondell Chemical Company ("Lyondell") through an LBO financed entirely by debt secured by Lyondell's assets. The LBO left Lyondell with nearly \$21 billion in secured debt, where \$12.5 billion of the loan proceeds were used to cash-out Lyondell stockholders (the "LBO Consideration"). Just over a year later, Lyondell sought chapter 11 relief in the Southern District of New York. At the time of the filing, Lyondell's unsecured creditors' right to payment on their claims remained subject to the outstanding \$21 billion secured loan. The Court specifically noted that in connection with the LBO, the company's assets had been depleted by the \$12.5 billion payment of loan proceeds to stockholders—"who, under the most basic principles of U.S. insolvency law, are junior to creditors in right of payment." Opinion at *1.

To bolster the recoveries possibly available for the unsecured creditors, Lyondell's plan of reorganization (the "Plan") created multiple litigation trusts, each of which was assigned the right to pursue certain types of claims.² The trust at issue in this litigation (the "Creditor Trust") received the right to prosecute certain Lyondell creditors' *state law* avoidance

¹ Section 546(e) of the Bankruptcy Code provides 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 . . . settlement payment . . . 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." 11 U.S.C. § 546(e).

² For example, one trust received the fiduciary-duty claims against Basell's and Lyondell's officers and directors, while another obtained all of the *federal* fraudulent transfer claims under § 548 of the Bankruptcy Code against shareholders that received LBO Consideration.

claims (the “Claims”) against the cashed-out stockholders. Pursuant to the Plan, after the Lyondell estate abandoned its right under § 544³ of the Bankruptcy Code, the creditors assigned their Claims to the Creditor Trust.

The Creditor Trust then sued certain shareholders in state court for state law fraudulent conveyance avoidance claims arising out of the LBO. A group of defendants—primarily investment banking houses, brokerage firms and financial institutions—removed the state proceeding to the Bankruptcy Court and filed a motion to dismiss the state law claims, relying heavily on the protections afforded by § 546(e)’s securities-contract safe-harbor provisions.

B. The Holding

The Court rejected the defendants’ two primary arguments that § 546(e) both (i) protects against and (ii) preempts individual claimants’ state law fraudulent transfer claims. Making quick work of the Defendants’ first argument that § 546(e) served as a valid defense to state law claims for all purposes, the Court held that § 546(e) provided no defense to a state law fraudulent transfer action because “there is no statutory text making section 546(e) applicable to claims brought on behalf of individual creditors, or displacing their state law rights.” *Id.* at *6. The defendants’ argument that the existence of § 546(e) (and the debtors’ rights to pursue such claims under § 544 of the Bankruptcy Code) preempted the Creditor Trust’s claims fared no better, but in reaching its preemption holding, the Court offered important insights into the purposes of the Bankruptcy Code, § 546(e), and competing securities-contract safe-harbor precedents.

The defendants argued that § 546(e) preempted individual creditors’ state law avoidance actions because such state actions obstruct the “accomplishment and execution of the full purposes and objectives of Congress.” *Id.* at *10 (quoting *Niagara Mohawk Power Corp. v. Hudson River-Black River Regulation Dist.*, 673 F.3d 84, 95 (2d Cir. 2012)). Section 546(e) reflected Congress’s intent to protect securities-contract transfers, defendants argued, so state laws that challenge the same transfers must yield to Congress’s purpose.

Relying heavily on *In re Tribune Co. Fraudulent Conveyance Litigation*, 499 B.R. 310 (S.D.N.Y. 2013), a recent Southern District of New York decision that also refused to use § 546(e) to limit individual creditors’ state law avoidance actions, the Court refused to find that individual claimants’ state law avoidance actions obstructed the Bankruptcy Code’s purpose. In support, the Opinion suggested that as “quite obvious to those in the bankruptcy community,” bankruptcy addresses “*many* competing concerns,” and “[i]t is not at all clear that Section 546(e)’s purpose with respect to securities transactions trumps all of bankruptcy’s other purposes.” *Id.* at *11 (quoting *In re Tribune*, 499 B.R. at 317). The Opinion also credited *Tribune*’s finding that Congress could have—if it desired—expressly preempted these state

³ Section 544 of the Bankruptcy Code provides that “the trustee may avoid . . . any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim.” 11 U.S.C. § 544(b)(1).

fraudulent transfer laws, as Congress did when it preempted state laws enabling individual claimants to recover certain charitable contributions.⁴

The Court also rejected the defendants' argument that the Claims obstructed the purpose of § 564(e). To reach this conclusion, the Opinion traced § 546(e)'s legislative history and determined that Congress enacted the section to guard the financial *markets* against a "ripple effect" caused by the insolvency of a single commodity or security firm. Section 546(e)'s purpose was not to protect "individual investors who are beneficial recipients of insolvents' assets," and the Court refused to find that § 546(e) preempted an action against "cashed out beneficial holders of stock, at the end of the asset dissipation chain." *Id.* at *19.

The Opinion noted the contrary result reached by the court in *Whyte v. Barclays Bank PLC*,⁵ a recent decision of the Southern District of New York that held § 546(g) of the Bankruptcy Code⁶ impliedly preempted similar state law fraudulent transfer claims. Relying heavily on *In re Tribune*, the Opinion distinguished *Whyte* on several grounds. *Id.* at *19–23. First, in *Whyte*, the plan of reorganization created just one litigation trust to prosecute both estate and creditor causes of action, effectively allowing the trust to pursue causes of action on the estate's behalf that § 546(g) barred the trustee from bringing on its own. The Creditor Trust in *Lyondell*, by contrast, holds "only *creditor* claims," assigned to it by the creditors themselves after the estate abandoned its § 544 rights to the Claims. *Id.* at *20. Furthermore, the Opinion criticized *Whyte* for declining to apply the courts' "usual presumption against implied preemption," and refusing to analyze thoroughly the *Whyte* defendants' claim that voiding the challenged payments would create market disruption. *Id.* at *21–22. As a result, the Opinion qualified *Whyte* and refused to dismiss the Lyondell individual claimants' state law constructive fraudulent transfer claims.

While the Court did not dismiss the Creditor Trust's Claims outright, the Court did narrow the claims that could proceed and noted the possible availability of certain defenses that could limit or preclude the successful prosecution of the Claims. First, the Court dismissed certain state law intentional fraudulent conveyance claims (while allowing the Creditor Trust to replead those claims), on the basis that the complaint did not adequately plead an actual intent by the company to defraud its creditors. *Id.* at *29–34. The Court also dismissed the Claims that had been assigned to the Creditor Trust by the secured lenders to the LBO, on the basis that such lenders had ratified the loans and therefore could not claim to have been defrauded by the transactions. *Id.* at *27–29. The Court left for another day the issue of the effect the dismissal of these claims (which constituted a substantial portion of the total claims being pursued) would have in limiting the amount any one shareholder would have to disgorge if the

⁴ See 11 U.S.C. § 544(b)(2) ("Any claim by any person to recover a transferred contribution [to charity] under Federal or State law in a Federal or State court shall be preempted by the commencement of the case.").

⁵ 494 B.R. 196 (S.D.N.Y. 2013).

⁶ Section 546(g) 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, 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 commencement of the case, except under section 548(a)(1)(A) of this title." 11 U.S.C. § 546(g).

dividends were ultimately avoided. *Id.* at *29 n.182. Additionally, the Court dismissed any claims asserted against entities that acted as conduits or nominees by passing on payments to others, because only beneficial owners can be held liable as fraudulent transfer recipients. *Id.* at *26–27. Finally, while the defendants sought dismissal of the claims on the basis that the entire LBO transaction should be collapsed and that once collapsed the claims fell away because Lyondell was a mere conduit for the payments, the Court held that such defenses could not be proven on the face of the complaint and could be raised at a later date. *Id.* at *23–26.

The Opinion's Importance

The Opinion adds to the developing, and to date inconsistent, case law on the question of the extent to which the § 546 safe harbors preempt or otherwise preclude the prosecution of state law avoidance actions by creditors following the confirmation of a plan of reorganization. By endorsing the *Tribune* ruling, the Opinion may signal a shift (at least in the Southern District of New York) towards allowing such claims to be filed against shareholders in a failed LBO. It remains to be seen whether other courts will follow these decisions or whether these claims ultimately will be able to be successfully prosecuted to judgment.

* * *

Please feel free to contact Lisa Schweitzer (lschweitzer@cgsh.com), Sean O'Neal (soneal@cgsh.com), or any of your regular contacts at the firm if you have any questions.

Office Locations

NEW YORK

One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON

2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS

12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS

Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON

City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW

Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT

Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE

Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME

Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN

Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG

Cleary Gottlieb Steen & Hamilton (Hong Kong)
Hysan Place, 37th Floor
500 Hennessy Road
Causeway Bay
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING

Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES

CGSH International Legal Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO

Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299

ABU DHABI

Al Sila Tower, 27th Floor
Sowwah Square, PO Box 29920
Abu Dhabi, United Arab Emirates
T: +971 2 412 1700
F: +971 2 412 1899

SEOUL

Cleary Gottlieb Steen & Hamilton LLP
Foreign Legal Consultant Office
19F, Ferrum Tower
19, Eulji-ro 5-gil, Jung-gu
Seoul 100-210, Korea
T: +82 2 6353 8000
F: +82 2 6353 8099