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Client Alert

Financial Restructuring Practice Group

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Second Circuit Holds that State Law Constructive Fraudulent Transfer Claims Brought By Individual Creditors are Preempted under Section 546(e) of the Bankruptcy Code

On March 24, 2016, the U.S. Court of Appeals for the Second Circuit (the "**Court**") ruled that former shareholders of the debtor Tribune Media Company ("**Tribune**"), who were cashed out in a leveraged buyout ("**LBO**"), would be protected from state law constructive intent fraudulent conveyance claims by virtue of the "safe harbor" protection of Section 546(e) of the Bankruptcy Code.[1] The Court discussed federal preemption principles to extend the safe harbor shareholder protection to lawsuits brought by creditor groups who were authorized to bring such claims by the Bankruptcy Court.

Background and Applicable Statutes

In 2007, Tribune's LBO resulted in the cash out of its' shareholders. The funds were first transferred to financial intermediaries who then made distributions to shareholders for their shares. In 2008, Tribune filed for bankruptcy. The Creditors Committee timely brought an "actual intent" fraudulent transfer claim under federal bankruptcy law[2] against the shareholders and others. It did not sue the shareholders for such transfers under state law "constructive intent" fraudulent conveyance statutes.[3]

In 2011, the Bankruptcy Court granted the appellants' motion to lift the Bankruptcy Code's automatic stay with respect to their alleged state law fraudulent conveyance claims, holding that the Creditors Committee's election not to bring state law constructive intent fraudulent conveyance claims within the two-year period of limitations under Section 544 of the Bankruptcy Code meant that the appellants regained their individual right under state law to bring such claims. The Bankruptcy Court noted that it was not ruling on whether the appellants had standing to bring the claims or whether the claims were preempted by the Section 546(e) safe harbor. The debtor's plan of reorganization terminated the Creditors Committee and transferred their federal actual intent fraudulent transfer claims to a litigation trust (the "**Litigation Trust**"). It also provided that the appellants could pursue LBO-related state law fraudulent conveyance claims.

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The shareholders were then sued in several federal and state courts, which actions were ultimately transferred and consolidated (with the Litigation Trust litigation) in a multi-district New York proceeding. The District Court thereafter granted the Tribune shareholders' motion to dismiss holding that the automatic stay deprived the appellants of statutory standing because the Litigation Trust was suing to avoid the same transfers (albeit under different legal theories). The District Court rejected the shareholders' argument that the state law constructive intent fraudulent conveyance claims were barred by Section 546(e).

The Second Circuit's Decision

The Court quickly dispensed with the issue of whether the appellants lacked standing because of the automatic stay. In overturning the District Court's ruling, the Court noted that the Bankruptcy Court had modified the automatic stay "for cause" to allow the appellants' litigation to be brought knowing that the Litigation Trust litigation was pending. But that technical issue did not give appellants the ultimate relief that they were seeking because the Court then overruled the District Court and held that the Section 564(e) safe harbor applied to the appellants' litigation.

In discussing Section 546(e), the Court first addressed the issue of federal preemption. Under the "implied preemption" doctrine, state laws are preempted to the extent of any conflict with federal statute. The Court rejected the appellants' argument that the presumption against preemption applied because fraudulent conveyance claims fall squarely within the police powers and the domain of state law. The Court noted that once a party enters bankruptcy, the Bankruptcy Code "constitutes a wholesale preemption of state laws regarding creditors' rights."[4] Additionally, the policies underlying Section 546(e) involve protection of securities markets – an area highly regulated by federal law that reflect important federal concerns.

The Court was highly skeptical that fraudulent transfer claims automatically reverted to creditors if not brought within the two year statute of limitations by the bankruptcy estate representative. Ultimately, the Court determined that, under federal preemption principles, Section 546(e) was intended to protect the securities market from certain transactions (such as constructive intent fraudulent transfer claims) whether they were brought by the bankruptcy estate representative, or by creditors of the debtor after the two year statute of limitations period expired. The Court commented that "unwinding settled securities transactions by claims such as appellants would seriously undermine - - a substantial understatement - - markets in which certainty, speed, finality and stability are necessary to attract capital."[5] The Court rejected the argument made in *Lyondell*,[6] that Section 546(e) does not apply to LBOs because the claw back is being sought from the stockholders rather than the financial intermediaries.[7]

Conclusion

There is now a definitive decision at the court of appeals level with respect to the application of Section 546(e) in the LBO context where shareholders are defendants in state law constructive intent fraudulent transfer law suits brought by individual creditors after the bankruptcy estate representative has let the Bankruptcy Code statute of limitations expire. This decision should have application in *Sem Group*[8] and *Lyondell*, where the same litigation tactic has been employed by individual creditor groups. Traditional targets of an LBO fraudulent transfer claim can breathe a collective sigh of relief because *Tribune* has closed a potential loophole. But they are not fully out of the woods. The Court did not address the validity of the federal actual intent fraudulent transfer claim pending under Section 548(a)(1) since such claims are expressly carved out from the Section 546(e) safe harbor. However, in the LBO context, those claims are much harder to prove against non-insiders like shareholders.

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[1] That section bars a trustee or debtor in possession from bringing actions to avoid a transfer made by or to (or for the benefit of) certain financial intermediaries, including a "financial institution" or "securities clearing agency" in connection with a "securities contract.

[2] An actual intent fraudulent transfer claim is a transfer made with actual intent to hinder, delay or defraud creditors of the debtor.

[3] A state law constructive fraudulent transfer claim is generally a transfer made for less than reasonably equivalent value (or fair consideration) when the debtor is insolvent (or under-capitalized) or rendered insolvent (or under-capitalized) by the transfer.

[4] *In re Tribune Co. Fraudulent Conveyance Litig.*, Case No. 13-3992, at 19 (2d Cir. Mar. 24, 2016).

[5] *Id.* at 40.

[6] *In re Lyondell Chem. Co.*, 503 B.R. 348 (Bankr. S.D.N.Y. 2014) *as corrected* (Jan. 16, 2014).

[7] *See In re Tribune*, Case No. 13-3992, at 41.

[8] *Whyte v. Barclays Bank PLC*, Case No. 13-2653-cv.