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CLIENT PUBLICATION

FR&I | MAY 2, 2016

Making the Safe Harbors Safe Again: United States Court of Appeals for the Second Circuit Holds That State Law Constructive Fraudulent Conveyance Claims Brought by Creditors Are Preempted by the Safe Harbor of Section 546(e) of the Bankruptcy Code

In a March 29, 2016 decision,[1] the United States Court of Appeals for the Second Circuit (the "Court of Appeals") held that creditors are preempted from asserting state law constructive fraudulent conveyance claims by virtue of the Bankruptcy Code's "safe harbors" that, among other things, exempt transfers made in connection with a contract for the purchase, sale or loan of a security (here, in the context of a leveraged buyout ("LBO")), from being clawed back into the bankruptcy estate for distribution to creditors. The decision will serve to promote finality and certainty for investors by limiting the circumstances (*e.g.*, to cases of intentional fraud) under which securities transactions can be unwound after a bankruptcy filing.

Background

In 2007, Tribune Media Company ("Tribune") borrowed over $11 billion which, combined with a $315 million equity contribution, was used in part to cash out its shareholders for over $8 billion. Tribune transferred the funds to a "securities clearing agency" or other "financial institution,"[2] acting as intermediaries in an LBO transaction. Those intermediaries paid the funds to Tribune's shareholders in exchange for their shares, which shares were returned to Tribune.

Tribune filed for bankruptcy relief on December 8, 2008. In November 2010, the Official Committee of Unsecured Creditors (the "Committee") commenced an action under Section 548(a) of the Bankruptcy Code, alleging that the LBO-related payments, which represented a premium price above the trading range per share, were avoidable as *intentional* fraudulent conveyances.[3] The Committee did not, however, assert claims for *constructive* fraudulent conveyances.

1 *In re Tribune Co. Fraudulent Conveyance Litig.*, No. 13-3875-CV, 2016 WL 1226871 (2d Cir. Mar. 29, 2016).

2 As such terms are used in Section 546(e) of the Bankruptcy Code.

3 Section 544(b) of the Bankruptcy Code empowers a trustee (or debtor in possession) to avoid a transfer by the debtor which is voidable under applicable law by an unsecured creditor. In addition, Section 548(a) of the Bankruptcy Code provides the trustee (or debtor in possession) with independent causes of action under the Bankruptcy Code for intentional fraudulent transfer and constructive fraudulent transfer. Section 546(a)

In March of 2011, two groups of unsecured creditors moved the Bankruptcy Court for an order finding that after expiration of the Committee's two-year period within which it (as a representative of the Debtor's estate) could bring avoidance claims, eligible creditors regained their pre-bankruptcy right to prosecute their own state law constructive fraudulent conveyance claims. These unsecured creditors also sought an order modifying the automatic stay solely to permit the immediate filing of their complaint.

In April of 2011, the Bankruptcy Court modified the stay, reasoning that because the Committee had elected not to bring constructive fraudulent conveyance actions within the statute of limitations, the unsecured creditors regained the right to prosecute any such claims. The Bankruptcy Court clarified, however, that it was not deciding whether the individual creditors had statutory standing to bring such claims, or whether the claims were preempted by Section 546(e) of the Bankruptcy Code, which bars a trustee from avoiding transfers by or to certain specified financial intermediaries that, among other things, constitute a "settlement payment" or a "transfer" "in connection with a securities contract" (in each case, except in the case of avoidance actions based on intentional fraud and brought under Section 548 of the Bankruptcy Code).[4]

In July 2012, the Bankruptcy Court confirmed Tribune's plan of reorganization (the "Plan"). The Plan terminated the Committee and transferred responsibility for prosecuting the intentional fraudulent conveyance action to a litigation trust. The Plan also provided that the unsecured creditors could pursue all LBO-related causes of action arising under state fraudulent conveyance law, except for the federal intentional fraudulent conveyance and other LBO-related claims being pursued by the litigation trust. The unsecured creditors' various state law fraudulent conveyance claims were consolidated with the litigation trust's ongoing federal intentional fraud claims in a multi-district litigation proceeding that was transferred to the Southern District of New York (the "District Court") in December of 2011.[5]

The Tribune shareholders moved to dismiss the unsecured creditors' claims. In September of 2013, the District Court ruled in favor of the shareholders. The District Court rejected Appellants' Section 546(e) preemption argument, holding that the prohibition on avoiding the designated transfers applied only to a bankruptcy trustee (and not to creditors bringing state law fraudulent conveyance claims that they had the right to bring prior to the bankruptcy filing). Nevertheless, the District Court held that the automatic stay deprived Appellants of statutory standing to pursue their claims so long as the litigation trustee was pursuing the avoidance of the same transfers

of the Bankruptcy Code provides for a two-year statute of limitations, running as of the bankruptcy filing, for a trustee (or debtor in possession) to commence avoidance actions under either Section 544 or 548.

4 Specifically, Section 546(e) provides, in pertinent part: "Notwithstanding [S]ections 544 … [and] 548(a)(1)(B) ... the *trustee* may not avoid a transfer that is a … 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, 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 … that is made before the commencement of the case, except under Section 548(a)(1)(a) of this title" (emphasis added).

5 The term "Appellants," as used herein, includes the litigation trust as well as the unsecured creditors who moved to prosecute their own state law constructive fraudulent conveyance claims (as described above).

(albeit under a different legal theory), and, therefore, granted the Tribune shareholders' motion to dismiss. Appellants appealed the District Court's dismissal for lack of statutory standing, and the Tribune shareholders cross-appealed from the District Court's rejection of their argument that the Appellants' claims were preempted by Section 546(e) of the Bankruptcy Code.

Decision

The Court of Appeals addressed two issues: first, whether Appellants are barred by the automatic stay from bringing state law constructive fraudulent conveyance claims while avoidance claims by the litigation trustee are ongoing; and if not, whether such claims are preempted by the safe harbor of Section 546(e) of the Bankruptcy Code.

The Automatic Stay Did Not Bar Appellants from Bringing State Law, Constructive Fraudulent Transfer Claims

The Court of Appeals held that Appellants were not barred by the automatic stay from bringing state law constructive fraudulent conveyance claims. First, the Bankruptcy Court had granted Appellants relief from the automatic stay with respect to the filing of such claims on numerous occasions, all with no objection by the Tribune shareholders. Moreover, the confirmed Plan expressly allowed Appellants to pursue any and all claims related to the LBO arising under state fraudulent conveyance law. As a result, *if* Appellants had actionable state law constructive fraudulent conveyance claims, assertion of such claims was not subject to the automatic stay.

Appellants' State Law Fraudulent Conveyance Claims Were Preempted by Section 546(e) of the Bankruptcy Code

Next, the Court of Appeals analyzed whether Section 546(e) preempted Appellants' state law fraudulent conveyance claims. As noted above, Section 546(e) expressly prohibits trustees from using their avoidance powers against certain transfers, including transfers by or to financial intermediaries that are settlement payments or in connection with a securities contract. The statute does not, however, reference claims brought by individual creditors. Additionally, Section 546(e) creates an exception to the safe harbor for claims brought by a trustee under Section 548 of the Bankruptcy Code based on an intentional fraudulent transfer theory (such as the claims being pursued by the litigation trust).

Appellants argued that if the trustee fails to act to enforce state law avoidance claims within the statutorily proscribed period, the claims then revert to creditors who may pursue their own state law fraudulent conveyance actions. The Court of Appeals disagreed, concluding that "[o]nce a party enters bankruptcy, the Bankruptcy Code constitutes a wholesale preemption of state laws regarding creditors' rights." Here, the Court of Appeals found that once Tribune entered bankruptcy, the creditors' avoidance claims were vested in the federally appointed bankruptcy trustee, and the disposition of these federal law claims extinguishes the right of creditors to bring state law fraudulent conveyance claims. Moreover, the Court of Appeals determined that nothing in the Bankruptcy Code supports the inference that such claims revert to creditors upon expiration of the statute of limitations or the lifting of the automatic stay. [6]

[6] The Court of Appeals noted that statutes of limitation usually are intended to limit the assertion of stale claims and to provide peace to possible defendants, and not to change the identity of authorized plaintiffs without some express language to that effect.

Appellants also argued that the plain language of Section 546(e) provides that only a "trustee," and not creditors acting on their own behalf, is barred from bringing state law constructive fraudulent conveyance claims that are otherwise covered by the language of the safe harbor. The Court of Appeals, however, stated that it would be illogical to limit trustees to intentional fraud claims, while not extinguishing constructive fraud claims, but rather leaving those same constructive fraud claims to be brought later by individual creditors. Indeed, such piecemeal actions by creditors would directly contradict the intent of the Bankruptcy Code's avoidance powers, which is to allow prosecution of avoidance claims for the benefit of the estate. Finally, Appellants argued that the presumption against federal preemption of state law claims applies because fraudulent conveyance claims are an area traditionally recognized as being governed by state law. The Court of Appeals again disagreed, stating that the regulation of creditors' rights has a history of significant federal presence, so there is no measureable concern about federal intrusion into traditional state domains.

From a policy perspective, the Court of Appeals stated that allowing creditors to bring claims a bankruptcy trustee would be barred from bringing under Section 546(e), only after the trustee fails to exercise powers it does not have, would increase the risk of market disruption by lengthening the period of uncertainty for intermediaries and investors with respect to which pre-bankruptcy transactions could be unwound. Moreover, the entire purpose of Section 546(e) is to protect the national and heavily regulated financial markets from disruption by limiting creditors' rights, an intentional and notable conflict with the Bankruptcy Code's goal of maximizing the assets available to creditors. As a result, the Court of Appeals held that Appellants' state law constructive fraudulent transfer claims are preempted by Section 546(e) of the Bankruptcy Code.

Discussion

Section 546(e) was intended to protect from avoidance powers transfers made by or to (or for the benefit of) financial intermediaries and other protected parties in connection with securities contracts or which constitute settlement payments (*i.e.*, a payment representing the completion of a securities transaction). Prior to this decision, creditors resorted to plan structures that authorized them (or a creditor trust) to pursue their state fraudulent transfer claims directly (as opposed to via the bankruptcy trustee) in an attempt to avoid the effect of the safe harbors and to challenge transactions made pursuant to securities contracts in connection with LBO transactions. Lower courts had reached different conclusions as to the propriety of these structures, creating a considerable loophole in the safe harbor protections.

The decision in Tribune forecloses an end run around the Bankruptcy Code safe harbors by preventing individual creditors from bringing claims that a bankruptcy trustee (or debtor in possession) would be barred from bringing. Allowing such actions would have greatly diminished the effectiveness of the safe harbors and led to market uncertainty. Accordingly, this decision should be a welcome result for market participants seeking greater certainty regarding pre-bankruptcy transactions, especially in light of prior decisions that reached contrary conclusions. However, it remains to be seen whether other circuit courts will follow the Second Circuit's decision in Tribune.

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