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Legal Update
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Southern District of New York Deepens Internal Split Over Loophole in Bankruptcy Safe Harbor for Capital Markets Transactions

The Bankruptcy Court for the Southern District of New York recently held in *Edward S. Weisfelner, as Litigation Trustee of the LB Creditor Trust v. Fund 1., et al. (In re Lyondell Chemical Company, et al.)*[1] ("Lyondell"), that section 546(e) of the Bankruptcy Code does not bar fraudulent transfer claims when such claims are brought by an entity other than the bankruptcy trustee (or its successors) under state fraudulent transfer laws rather than the Bankruptcy Code. Section 546(e) is the Bankruptcy Code's safe harbor for certain pre-bankruptcy transfers made in connection with securities contracts by, to or for the benefit of financial institutions.

This decision expands upon another recent decision by the District Court for the Southern District of New York in litigation related to the Tribune chapter 11 bankruptcy ("Tribune")[2] that similarly limited the scope of the section 546(e) safe harbor.

Notably, the *Lyondell* decision also went to great lengths to distinguish and challenge the reasoning of a recent conflicting decision by the District Court for the Southern District of New York in litigation related to the SemGroup chapter 11 bankruptcy ("SemCrude")[3] that, in contrast to the *Lyondell* and *Tribune* decisions, held that state law fraudulent transfer claims brought by a litigation trust organized pursuant to a chapter 11 plan *are impliedly preempted* by a similar Bankruptcy Code safe harbor for swap transactions.

While it remains to be seen how this split of authority will be resolved, the *Lyondell* decision would seem to embolden further efforts by creditors to obtain recoveries on state law fraudulent transfer claims that would otherwise be barred by the Bankruptcy Code safe harbors if brought by a trustee, a debtor or a representative of the debtor.

The Section 546(e) Safe Harbor

The Bankruptcy Code contains several provisions that allow the bankruptcy trustee (or its successors) to unwind and avoid certain pre-bankruptcy payments and transfers made by the debtor if such payments or transfers are preferential or are either constructively or intentionally fraudulent. These "avoidance" powers normally operate to recover assets that were transferred away from the bankruptcy estate, thereby ensuring greater equality in treatment among creditors. With respect the recovery of fraudulent transfers, the Bankruptcy Code allows bankruptcy trustees to assert claims under both the Bankruptcy Code and under applicable state law fraudulent transfer provisions.

However, because of the systemic risk to securities and other financial markets that might occur if such markets were subject to these

avoidance powers, Congress enacted (and, over time, expanded the scope of) section 546(e) of the Bankruptcy Code. Section 546(e) provides a "safe harbor" exempting from avoidance by "the trustee" any "margin payments," "settlement payments" and transfers in connection with "securities contacts," "forward contracts" and "commodity contracts" made by, to or for the benefit of certain parties such as stockbrokers and financial institutions. Section 546(e) provides, in relevant part:

> "… ***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, 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).

Prior to the *Lyondell* and *Tribune* decisions, courts had largely interpreted the safe harbor created by section 546(e) to broadly immunize transactions falling within the purview of the above statutory language from avoidance.

Lyondell

In December 2007, Basell AF S.C.A. ("Basell") completed a leveraged buyout of Lyondell Chemical Company ("Lyondell Chemical") that was completely financed by $21 billion of new secured indebtedness, $12.5 billion of which was paid to Lyondell's shareholders for their shares. Less than 13 months later, Lyondell Chemical filed a chapter 11 bankruptcy petition in the Bankruptcy Court for the Southern District of New York.

Lyondell Chemical's chapter 11 plan was confirmed and, among other things, provided for the creation of a trust (the "Creditor Trust") to pursue litigation claims for the benefit of certain creditors. That plan of reorganization also affirmatively abandoned the Lyondell Chemical estate's ownership of state law-based fraudulent transfer claims, while simultaneously assigning the state law fraudulent transfer claims of creditors holding unsecured trade claims, funded debt claims and senior and subordinated secured deficiency claims to the Creditor Trust. Importantly, by abandoning and then assigning these claims, the plan of reorganization created a structure whereby the Creditor Trust ostensibly stood in the shoes of individual creditors, rather than in the shoes of Lyondell Chemical's estate.

The Creditor Trust then sued former Lyondell Chemical shareholders in New York State Supreme Court, alleging that $12.5 billion in payments following the leveraged buyout were avoidable fraudulent transfers under applicable state law. Notably, the Creditor Trust's claims were not brought under the Bankruptcy Code's fraudulent transfer provisions.

A sizeable group of defendants removed the action from the New York State Court to the District Court for the Southern District of New York, which promptly referred the case to the Bankruptcy Court.

The defendants then sought dismissal of the case, arguing (among other things)[4] that the language of the section 546(e) safe harbor was broad enough to provide a substantive defense to the state law fraudulent transfer claims. The defendants further argued that, in the absence of a similar state law safe harbor, the section 546(e) safe harbor was in direct conflict with the state law fraudulent transfer laws, and that the state law fraudulent transfer laws were therefore preempted by section 546(e).

The Ruling and Its Rationale

Citing heavily to the *Tribune* decision, the *Lyondell* Court first held that the plain language of the section 546(e) safe harbor was not broad enough to exempt the Creditor Trust's state law claims. In support of this, the Court reasoned that the language of section 546(e) only exempted avoidance claims brought by "the trustee," and found it significant that the statute was silent as to avoidance claims brought by or on behalf of individual creditors. Because of this silence, and because the claims were asserted on purely state law grounds, the Court held that nothing in the statutory text of section 546(e) operated to bar the state law claims.

The Court next held that the state law constructive fraudulent transfer laws were neither expressly nor impliedly preempted by section 546(e). With respect to express preemption, and again citing heavily to the *Tribune* decision, the Court reasoned that there was no preemption because it found nothing to indicate that Congress had specifically intended to withdraw any specified powers from the states in enacting section 546(e).

Turning to the question of implied preemption, the Court found that Congress had not shown an intention to occupy the fields of avoidance or recovery of fraudulent transfers, and that section 546(e) did not therefore conflict with the state laws in a manner that would mandate the preemption of state fraudulent transfer laws. To the contrary, the Court concluded that the totality of Congress' intent with respect to bankruptcy policy *on the whole* (rather than just Congress' policy in enacting section 546(e)) includes a host of aims besides just protecting the nation's financial markets from the instability that might be caused by the avoidance of certain financial transactions.

According to the Court, one of the most important of those aims is equality of distribution among creditors. And, like the Court in *Tribune*, the *Lyondell* Court cited to another section of the Bankruptcy Code to demonstrate that Congress knows how to, and is willing to, expressly preempt an individual creditor's state law claims, and noted that Congress had failed to expand the scope of the safe harbor to preempt such claims despite being asked to address this potential loophole. Finding intent in Congress's inaction, the *Lyondell* Court believed that Congress had "struck some balance between" the policy of market stability and preservation of an individual creditor's right to commence fraudulent conveyance actions under certain circumstances.

Finally, the Court reasoned that the bulk of the legislative history underlying section 546(e) evidenced an intent to protect against market disruptions that might be caused by avoidance of payments made to *market intermediaries* (i.e., brokers, nominees and other institutional financial entities), but was silent as to the disruptions that might be caused by unwinding payments to individual investors in those same markets. According to the Court, this meant that Congress was comfortable that the potential avoidance of payments to such investors (as the ultimate beneficiaries of the fraudulent transfers) would not create a systemic risk to the capital markets, and, therefore, did not implicate the concerns underlying the section 546(e) safe harbor.

Distinguishing and Challenging SemCrude

As noted above, the *Lyondell* Court also went to great lengths to distinguish and challenge the conflicting *SemCrude* decision.

In *SemCrude*, a litigation trust formed under a reorganization plan in the SemGroup chapter 11 case had asserted constructive fraudulent transfer claims against two Barclays entities with respect to the novation of a swap portfolio by certain SemGroup entities. As in *Tribune* and

Lyondell, the *SemCrude* defendants sought dismissal based on the application of the section 546(g) safe harbor for payments related to swap agreements[5] (which is substantially similar to the section 546(e) safe harbor) to preempt state law fraudulent transfer claims. The *SemCrude* Court agreed, and held that when creditor claims are assigned to a litigation trust pursuant to a chapter 11 plan of reorganization, the section 546(g) swap safe harbor impliedly preempts any state law fraudulent transfer actions.

The *Lyondell* Court recognized the conflict posed by the *SemCrude* decision, and attempted to distinguish *SemCrude* by noting that the *SemCrude* plan of reorganization provided for a single trust to act on behalf of both the bankruptcy trustee and certain individual creditors. According to the *Lyondell* Court, this meant that unlike the Creditor Trust (which was theoretically purely a creature of contract representing the interests of individual Lyondell creditors), the *SemCrude* litigation trust, in its capacity as successor to the *bankruptcy trustee*, was barred by the plain language of the section 546(e) safe harbor from bringing state law fraudulent transfer claims.

The *Lyondell* Court then went on to question the "correctness" of the "bottom-line" judgment of the *SemCrude* decision. According to the *Lyondell* Court, the *SemCrude* Court should have given more deference to certain canons of statutory interpretation that would have mandated heavier presumptions against implied preemption. In this respect, the *Lyondell* Court felt that the *SemCrude* Court was wrong to conclude that there was a history of significant federal presence with respect to financial contract anti-avoidance safe harbors. The *Lyondell* Court applied a time-based rationale, and argued that the earliest of the safe harbors was first enacted in 1978, while the state law fraudulent transfer laws traced their roots back to the Uniform Fraudulent Transfer Act of 1918 (which in turn traced its roots back to the Statute of Elizabeth of 1571).

The *Lyondell* Court next reasoned that the *SemCrude* analysis had failed to consider the full purposes and objectives of Congress, which, according to the respective *Tribune* and *Lyondell* Courts, went beyond the scope of the safe harbors to larger questions of bankruptcy policy such as fostering equality of distribution among creditors.

Finally, the *Lyondell* Court reasoned that the *SemCrude* Court had improperly accepted the notion that voiding the payments at issue would create disruption to the markets. In this respect, the *Lyondell* Court again emphasized that the section 546(e) safe harbor was intended to protect only market intermediaries rather than individual market participants.

Implications

The *Lyondell* Court's interpretation of the section 546(e) safe harbor further highlights the deepening split in the Southern District of New York with regard the scope of the section 546(e) safe harbor. The split of authority with *Tribune* and *Lyondell*, on the one hand, and *SemCrude*, on the other hand, creates uncertainty among market participants regarding the scope of anti-avoidance safe harbors such as section 546(e). Taken together with *Tribune*, this ruling may further incent financial market participants to seek legislative action to expressly close what may be a loophole in the effectiveness of the Bankruptcy Code's anti-avoidance safe harbors with respect to financial transactions. In the interim, creditors are likely going to continue to bring state law fraudulent transfer claims as a means to recover additional value in situations where the debtor or its estate would be barred from bringing such claims under the Bankruptcy Code safe harbors.

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Endnotes

[1] Case No. 10-4609, 2014 WL 118036 (Bankr. S.D.N.Y., Jan. 14, 2014).

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

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

[4] The defendants also argued that (1) the Creditor Trust could not recover because the transferred funds were not property of the Debtors (e.g., the leveraged buyout proceeds had simply passed through the Debtor on their way to the Lyondell shareholders), (2) many of the defendants were merely conduits, (3) the Creditor Trust lacked standing to sue on behalf of certain lender plaintiffs because such lenders had ratified the transfers in question as part of the leveraged buyout process, and (4) the Creditor Trust had failed to satisfactorily plead claims for intentional fraudulent transfer. The Court rejected the first two of these arguments, but granted dismissal with respect to the claims of those lenders that ratified the leveraged buyout transaction, and with respect to the intentional fraudulent transfer claims (with leave to replead such intentional fraudulent transfer claims). A full analysis of those holdings is beyond the scope of discussion contained herein.

[5] *See* 11 U.S.C. § 546(g).

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