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Safe harbour neither bars nor pre-empts state law fraudulent transfer claims

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Introduction

Section 546(e) of the Bankruptcy Code curtails the power of a bankruptcy trustee to avoid, as fraudulent transfers, settlement payments made in securities transactions.(1) Nevertheless, the US Bankruptcy Court for the Southern District of New York recently held that Section 546(e) did not bar or pre-empt state law fraudulent transfer claims asserted by a litigation trustee on behalf of Lyondell Chemical Company's creditors.(2) The trustee had asserted those claims in order to avoid and recover the billions of dollars paid to shareholders from the leveraged buy-out of Lyondell. In so holding, the bankruptcy court followed the US district court's reasoning in the 2013 *Tribune Company* decision,(3) and departed from the contrary ruling of another district court in *Whyte v Barclays Bank PLC*.(4) The *Lyondell* decision also runs counter to other rulings that have, in similar but not identical settings, invoked Section 546(e) to pre-empt state law claims. If left undisturbed, the decision in *Lyondell* will likely bolster the position of unsecured creditors seeking to recover substantial sums of money paid to former shareholders of a corporate debtor in connection with a pre-bankruptcy leveraged buy-out. Given the interlocutory nature of the bankruptcy court's order, which ruled on threshold motions to dismiss, an immediate appeal in *Lyondell* appears unlikely. However, appeals from the *Tribune* and *Barclays* decisions are pending before the US Court of Appeals for the Second Circuit and those appeals will be heard in tandem in the coming months.(5) Thus, the Second Circuit may, in short order, have occasion to resolve important issues bearing on the statutory breadth and pre-emptive power of Section 546(e).

Federal pre-emption

Pre-emption is not a doctrine of bankruptcy, but rather one rooted in the supremacy clause of the US Constitution, which provides in relevant part that the "Laws of the United States... shall be the supreme Law of the Land".(6) Under this principle, "Congress has the power to pre-empt state law; state laws that conflict with federal laws are without effect."(7) In every pre-emption case, "'[t]he purpose of Congress is the ultimate touchstone,' which 'primarily is discerned from the language of the pre-emption statute and the statutory framework surrounding it,' as well as from 'the structure and purpose of the statute as a whole.'"(8)

Generally, three types of pre-emption exist:

> *"(1) express pre-emption, where Congress has expressly pre-empted local law; (2) field pre-emption, where Congress has legislated so comprehensively that federal law occupies an entire field of regulation and leaves no room for state law; and (3) conflict pre-emption, where local law conflicts with federal law such that it is impossible for a party to comply with both or the local law is an obstacle to the achievement of federal objectives."*(9)

The 'impossibility' and 'obstacle' branches of conflict pre-emption are described in more detail below.(10)

Additionally, there is a "presumption against pre-emption" that "operates most forcefully when Congress legislates 'in a field which the States have traditionally occupied,'

particularly 'regulation of matters of health and safety.'"(11) However, the presumption may be overcome "where 'a Congressional purpose to pre-empt... is clear and manifest.'"(12)

Section 546(e) safe harbour

Section 546(e) of the Bankruptcy Code provides a safe harbour from, and therefore operates as an affirmative defence against, avoidance claims brought by a bankruptcy trustee, or other entity authorised to wield the powers of such a trustee (hereinafter, an 'estate representative'),(13) under specific provisions of the Bankruptcy Code.(14) In general, Section 546(e) of the Bankruptcy Code provides that a bankruptcy trustee (or estate representative) may not avoid, among other things, payments made to complete or "settle" securities transactions involving stockbrokers, financial institutions, securities clearing agencies or certain other entities.(15) For example, "a settlement payment made by a stockbroker to a shareholder of the debtor (including a payment made in connection with a leveraged buyout) may be protected under section 546(e)." (16)

Congress enacted Section 546(e) to minimise systemic upheaval or "displacement" in the securities and commodities markets that would result if bankruptcy trustees were permitted to reverse or unwind, through their avoidance powers, a host of transfers or trades that had been settled.(17) In particular, Section 546(e) is intended to "prevent the 'ripple effect' created by 'the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected industry." (18) Further:

> *"[by] restricting a bankruptcy trustee's power to recover payments that are otherwise avoidable under the Bankruptcy Code, the safe harbor [provided under section 546(e)] stands 'at the intersection of two important national legislative policies on a collision course – the policies of bankruptcy and securities law.'"*(19)

Section 546(e) is not a defence against every form of fraudulent transfer claim. Specifically, Section 546(e) cannot be invoked as a defence when the trustee or estate representative is asserting a claim for intentional fraudulent transfer under Section 548 of the Bankruptcy Code.(20) This exception is narrow because, in a case asserting a claim for intentional fraudulent transfer, the trustee or estate representative will have to prove intent to hinder, delay or defraud creditors, rather than relying on the theory of constructive fraudulent transfer.(21) Moreover, the reach-back period under Section 548 is only two years before the bankruptcy filing date.(22) Thus, Section 548 will not be available if the bankruptcy trustee or estate representative is seeking to avoid a fraudulent transfer that occurred more than two years before the bankruptcy filing. Other fraudulent transfer statutes have reach-back periods longer than two years,(23) and depending on the circumstances, trustees or estate representatives might be able to take advantage of those longer reach-back periods by asserting claims derivatively under those other statutes, in accordance with Section 544(b) of the Bankruptcy Code. (24) However, Section 546(e) is a defence against claims brought under Section 544(b).

Courts have extended the 'safe harbour' provisions of Section 546(e) to include "various transactions involving publicly traded companies, including leveraged buyouts and repurchase agreements."(25) Moreover, even though the legislative history emphasises that Congress enacted Section 546(e) to protect public financial markets, some courts have relied on the plain language of that statute to extend its safe harbour to transactions involving stock that was not traded in those markets.(26)

Even though the express language of Section 546(e) makes it a defence against most avoidance claims asserted under the Bankruptcy Code, some courts have held that because Section 546(e) is a federal law, it pre-empts other types of state law claims that a bankruptcy trustee or estate representative may bring against shareholders. (27) These state law claims typically are for illegal shareholder distributions, breach of fiduciary duty and unjust enrichment. Courts invoking Section 546(e) pre-emption against these state law claims commonly do so on the basis of conflict pre-emption; they reason that because the state law claims are similar to fraudulent transfer claims and are seeking to recover the same payments that have been found unavoidable under Section 546(e), allowing recovery on these state law claims would render Section 546(e) meaningless and would frustrate the purpose of that statute.(28)

Lyondell and *Tribune* differ from the pre-emption cases described above because the Lyondell creditor trust and the Tribune creditors did not claim to be acting as bankruptcy trustees or estate representatives. By its express terms, Section 546(e) applies only to "the trustee" (and, by extension, an estate representative).(29) The plaintiffs in *Lyondell* and *Tribune* have argued that Section 546(e) does not apply to them or to their fraudulent transfer claims because they are creditors or persons acting on behalf of creditors and are not wielding the avoidance powers of a bankruptcy trustee. Instead, the plaintiffs gained (or regained) the right to pursue their avoidance claims under state law after the estate's right under the Bankruptcy Code to pursue avoidance actions was "deemed abandoned" under a confirmed Chapter 11 plan (in the case of *Lyondell*) or

after the two-year limitation period applicable to the estate's avoidance claims expired (in the case of *Tribune*).

Tribune case and decision

Tribune was a large media business that owned dozens of TV stations and newspapers and the Chicago Cubs baseball team. In 2007 investors led by billionaire Samuel Zell took control of Tribune through a leveraged buy-out that paid Tribune shareholders approximately $8 billion for their shares and increased Tribune's debt load from $5.3 billion to $14 billion. Tribune operated for almost a year after the leveraged buy-out but, amid the worldwide economic downturn, Tribune and its subsidiaries filed for bankruptcy protection in December 2008.(30)

In October 2010 the creditors committee appointed in the case obtained the bankruptcy court's permission to pursue claims arising out of the leveraged buy-out on behalf of the bankruptcy estate. The committee then filed a complaint against Zell, Tribune's officers and directors, financial advisers and others, asserting claims for breach of fiduciary duty, payment of illegal dividends, unjust enrichment and other legal theories. One count of the complaint named a number of Tribune's former shareholders individually as defendants and as representatives of a putative defendant class, and sought to avoid the payments to shareholders in connection with the leveraged buy-out as intentional fraudulent transfers. The committee did not allege that the payments were constructive fraudulent transfers avoidable under Sections 548 and 544(b). The two-year limitation period under Section 546(a) of the Bankruptcy Code was allowed to run with respect to those constructive fraudulent transfer claims.(31)

At the request of Tribune's bondholders, the bankruptcy court lifted the automatic stay, permitting the bondholders and other Tribune creditors to file their own constructive fraudulent transfer claims under state law against the former shareholders.(32) Starting in June 2011, plaintiffs commenced 44 actions in 21 states against more than 1,700 former Tribune shareholders, seeking to avoid under state law the billions of dollars that the shareholders had received from the leveraged buy-out as constructive fraudulent transfers.(33) These actions were consolidated in the US District Court for the Southern District of New York.(34) The defendants filed a joint motion to dismiss in November 2012 arguing, among other things, that Section 546(e) pre-empted the plaintiffs' constructive fraudulent transfer claims.

On September 23 2013 the district court in *Tribune* issued an opinion rejecting their pre-emption argument.(35) At the outset, the court determined that Section 546(e) did not apply to the avoidance claims of individual creditors because that statute "addresses its prohibition on avoiding settlement payments only to the bankruptcy trustee, and the Court works from the premise 'that Congress says in a statute what it means and means in a statute what it says there.'"(36)

The district court then turned to the defendants' argument in support of implied pre-emption – chiefly, that if the Tribune creditors' constructive fraudulent transfer claims were allowed to proceed, those claims would frustrate the purpose of Section 546(e) and stand as an obstacle to its accomplishment. The court observed that Congress "repeatedly indicated that it did not enact Section 546(e) to protect market stability to the exclusion of all other policies", such as the aim of making creditors of the bankruptcy estate whole.(37) For instance, when the Commodity Futures Trading Commission petitioned Congress to amend the statutory precursor to Section 546(e) to pre-empt state law constructive fraudulent transfer claims, Congress declined to do so.(38) Moreover, the court said that "on each of the eight occasions when it has amended Section 546(e), Congress has never added an express preemption provision".(39) Congress knows how to pre-empt state law claims of individual creditors when it intends to do so. As an example, the court cited Section 544(b)(2) of the Bankruptcy Code, which creates a safe harbour for charitable contributions and provides further that "[a]ny claim *by any person* to recover a transferred [charitable] contribution… under Federal or State law… shall be preempted by the commencement of the bankruptcy case."(40) Section 546(e), by contrast, "names only the [bankruptcy] trustee".(41) The court reasoned that Congress "struck some balance between various policy priorities, which means that it has determined that fraudulent conveyance actions are not necessarily and in all cases 'repugnant' to the interest of market stability."(42) It was not the court's function then to "upend Congress's balance between the operation of state and federal law, even if doing so would clearly benefit investors and markets."(43)

The district court in *Tribune* distinguished its pre-emption ruling from the decision rendered in *Whyte v Barclays Bank*.(44) In *Barclays* a confirmed Chapter 11 plan established a litigation trust, and authorised that trust to pursue avoidance actions as the estate representative and as the representative of individual creditors.(45) The litigation trust sued to avoid a pre-bankruptcy swap transaction, and Section 546(g) of the Bankruptcy Code, which provides a safe harbour for swap transactions, was raised as a defence.(46) The *Barclays* court determined that Section 546(g) impliedly pre-empted the fraudulent transfer claims of the litigation trust.(47) However, the court in *Tribune* concluded that *Barclays* had no bearing on its analysis because in *Barclays* the trust "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."(48) By contrast, the individual creditors pressing their claims in *Tribune* were "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 to [the litigation trust]."(49)

Although the district court in *Tribune* found no pre-emption of the creditors' fraudulent transfer claims, this did not translate ultimately into a favourable outcome for the creditors. The court observed that the confirmed Chapter 11 plan in *Tribune* had established a litigation trust, which now held the intentional fraudulent transfer claims originally filed by the creditors committee.(50) Because the *Tribune* litigation trust was pursuing its fraudulent transfer claims to attack the same shareholder pay-outs that the creditors were targeting, the court concluded that the automatic stay under Section 362 (a)(1) of the Bankruptcy Code deprived the creditors of standing to pursue their fraudulent transfer claims simultaneously.(51) Rather than holding the creditors' claims in abeyance until the trust completed its action, the court in *Tribune* dismissed the creditors' claims.(52)

The *Tribune* plaintiffs have appealed the district court's ruling to the Second Circuit, and the defendants in that proceeding have cross-appealed on the pre-emption issue. Thus, the Second Circuit may have occasion to address pre-emption, particularly if it reverses the district court on the automatic stay ruling. Reversal of the automatic stay ruling is certainly not out of the question, because the automatic stay was no longer in effect when the *Tribune* court chose to cite it as the basis for dismissing the creditors' claims. As the *Tribune* appellants have pointed out in their opening brief to the Second Circuit, the automatic stay was terminated by operation of law when the *Tribune* plan went effective, which occurred before the district court ruled on the motion to dismiss.(53) Moreover, the bankruptcy court in *Tribune* had lifted the automatic stay to allow the fraudulent transfer actions to be filed.(54) For these reasons, a decision affirming the district court based on the automatic stay hardly seems to be an inevitable result.

***Lyondell*: background**

The fraudulent transfer litigation in *Lyondell* arose from a pre-bankruptcy leveraged buy-out of Lyondell Chemical Company in 2007 that was financed through borrowings secured by the assets of Lyondell and many of its operating subsidiaries. The selling shareholders received, in connection with the leveraged buy-out, approximately $12.5 billion for their shares.(55)

In early 2009 the successor to Lyondell and numerous affiliates filed for bankruptcy protection. In April 2010 the bankruptcy court confirmed the debtors' plan of reorganisation, which among other things, provided that the "[d]ebtors shall be deemed to have abandoned" any and all rights to pursue avoidance claims under Section 544(b) against the former Lyondell shareholders. The confirmed plan also created litigation trusts to pursue claims arising from the leveraged buy-out for the benefit of creditors. One trust formed under the plan was the "litigation trust", which was assigned and had authority to prosecute all pending avoidance and other claims, except for the abandoned avoidance claims. Moreover, except for the abandoned claims, the plan provided that all of the debtors' non-pending but potential avoidance claims would be assigned to the litigation trust or retained by the reorganised debtors. Another trust formed under the plan was the "creditor trust", which received authority to prosecute, on behalf of creditors, state law fraudulent transfer claims against former Lyondell shareholders. In other words, instead of pursuing the claims on their own, the creditors contributed their claims to the creditor trust for prosecution on their behalf.(56)

In October 2010 the trustee of the creditor trust filed suit in New York state court, asserting only state law fraudulent transfer claims against numerous defendants, all of whom were alleged to have been Lyondell shareholders that received more than $100,000 for their shares as a result of the leveraged buy-out.(57) The suit was removed to federal district court, which in turn, referred the case to the bankruptcy court that had jurisdiction over the *Lyondell* reorganisation. Several motions were made to dismiss the trustee's suit, raising a number of defences, including the Section 546(e) safe harbour.

***Lyondell* rulings on Section 546(e)**

On January 14 2014 the bankruptcy court rendered its decision denying the motions to dismiss on the Section 546(e) issue.(58) Relying on the text of Section 546(e), the bankruptcy court determined that Section 546(e) was, by its terms, "inapplicable to state law claims brought on behalf of individual creditors."(59)The court emphasised that Section 546(e) "provides that 'the [bankruptcy] *trustee* may not avoid a transfer'".(60) As a result, Section 546(e) applied to claims that were available to trustees or estate representatives under specific provisions of the Bankruptcy Code. By contrast, the court said that "there is no statutory text making section 546(e) applicable to claims brought on behalf of individual creditors, or displacing their state law rights, by plain meaning or otherwise."(61) Section 546(e) did not bar those claims because the claims of the creditor trust were "not being asserted on behalf of the estate", but instead were

"asserted on behalf of individual creditors".(62)

Although the defendants had not sought dismissal based on express pre-emption, the bankruptcy court nevertheless turned to that branch of the doctrine, and found no basis for concluding that Congress had expressly pre-empted state law fraudulent transfer claims.(63) As for field pre-emption, the court observed that states have had fraudulent transfer laws on the statute books for over 200 years, and creditors have exercised their rights under those laws without resorting to bankruptcy proceedings. During the years in which federal bankruptcy laws have been in effect, those laws have coexisted with state fraudulent transfer statutes. Even today, Section 544(b) of the Bankruptcy Code provides trustees with the avoidance remedies available to creditors under state law, which hardly manifests an intent to wholly occupy the field of avoidance actions.(64)

The court then turned to conflict pre-emption, which has two branches: the impossibility branch and the obstacle branch. Impossibility occurs when "state law penalizes what federal law requires, or when state law claims directly conflict with federal law."(65) The conflict must overcome the presumption against pre-emption. In *Lyondell*, the court could not find such a conflict. The court observed that nothing in federal law requires shareholders to sell their stock in connection with a leveraged buy-out or otherwise. Moreover, state fraudulent transfer laws did not purport to regulate conduct; these laws merely assigned consequences to certain past conduct, and provided a right of action to unpaid creditors injured by that conduct.(66) Thus, the court found no basis for invoking pre-emption under the impossibility branch.

As for the obstacle branch, the court noted that the obstacle analysis "comes into play when state law is asserted to stand as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."(67) For state law to be pre-empted under the obstacle branch the "repugnance or conflict" must be "so direct and positive that the two acts cannot be reconciled or consistently stand together."(68)

Like the *Tribune* court, the court in *Lyondell* observed that the bankruptcy laws embody many competing concerns, only one of which is to ensure the stability of financial markets. The bankruptcy court then noted its agreement with *Tribune* that Congress did not enact Section 546(e) to protect financial markets to the exclusion of all other policies. Indeed, the bankruptcy court reiterated the *Tribune* court's observation that Congress failed to pre-empt state fraudulent transfer laws even when it was requested to do so. Furthermore, as the *Tribune* court had observed, when Congress decided that the protection of charitable gifts should override the maximisation of creditors' recoveries, Congress expressly pre-empted state fraudulent transfer laws with respect to charitable gifts in Section 544(b)(2). The court reasoned that Congress's failure to enact similar language in Section 546(e) was "powerful evidence that Congress did not intend for Section 546(e) to pre-empt state law."(69)

The bankruptcy court found other reasons for not invoking pre-emption under the obstacle branch. In any implied pre-emption analysis, said the court, one should look not only to the purposes of Section 546(e) alone but also to the other objectives and policies embodied in the Bankruptcy Code. In addition to making creditors of the bankruptcy estate whole, the Bankruptcy Code evinced the policy of ensuring a "ratable and equitable distribution of a debtor's assets to and among similarly situated creditors."(70) In furtherance of that policy, Congress vested bankruptcy trustees and estate representatives with powers to avoid transactions "induced and tainted by preference, illegality or fraud", and to recover transferred assets or their value for the benefit of all creditors.(71) Other relevant federal policies included "the traditional priority of creditors of insolvent companies over those companies' stockholders, as implemented by the absolute priority rule, which has been an element of U.S. insolvency law for over a hundred years."(72)

"Presumably," said the court, had Congress determined "that its interest in protecting markets (or market participants, which is not the same thing), should trump the historical priority of creditors over stockholders" and other historical concerns, it could have provided "for express preemption of state law constructive fraudulent transfer claims, just as it did with respect to charitable gifts".(73) Yet, "Congress did not do so, even though its enactment of section 544(b)(2) makes clear that it was well aware of that option."(74)

The bankruptcy court next considered the policies underlying Section 546(e), noting that even if they were "the *only* federal policies to be implemented, they would not require a finding that state constructive fraudulent transfer laws are repugnant to federal law, at least in a situation like this one."(75) The court reviewed the legislative history of Section 546(e) and concluded that Congress enacted Section 546(e) out of a concern to protect markets and market intermediaries, such as exchanges, clearing associations and depositories for investors, from the harmful "ripple effects" that would result from reversing market transactions.(76) By contrast, the court found nothing in the legislative history that evinced "a desire to protect individual investors who are beneficial recipients of insolvents' assets".(77) Clawing back leveraged buy-out payments from stockholders at the end of the asset transfer chain did not pose the same systemic risk to markets that Section 546(e) was intended to protect. The court said that those stockholders

could give back the leveraged buy-out payments "with no damage to anyone but themselves".(78) Thus, the court concluded that "at least in the context of an action against cashed out beneficial owners of stock, at the end of the asset dissipation chain, state fraudulent transfer laws do not stand as an obstacle to purposes and objectives of Congress."(79)

As in *Tribune*, the court in *Lyondell* was confronted with the *Barclays* decision holding that Section 546(g), which provided a safe harbour for swap transactions, impliedly pre-empted avoidance claims. Agreeing with the distinction drawn by the *Tribune* court, the court in *Lyondell* noted that *Barclays* involved a person who was wearing 'two hats' insofar as he was acting as estate representative and as a representative of individual creditors. By contrast, the *Lyondell* case had two separate trusts – the litigation trust and the creditor trust – and the creditor trust was asserting the avoidance claims of individual creditors that had been contributed to it, not avoidance claims held by the estate.(80) However, this distinction might not hold up on closer examination of the facts in *Lyondell*. In *Lyondell,* the individual acting as the trustee of the creditor trust was also serving simultaneously as trustee of the litigation trust.(81) In that sense, he is one person wearing 'two hats', just as the trustee was in *Barclays*. Moreover, the creditor trust and the litigation trust have the same advisory committee, are funded with estate assets and have the same beneficiaries who are all creditors of the estate.(82) These circumstances may cause one to ask whether the 'two hats' rationale adequately distinguishes *Lyondell* from *Barclays*.

This may explain why the bankruptcy court cited other reasons for not following *Barclays*. The bankruptcy court noted that the *Barclays* court had "declined to apply the usual presumption against implied preemption", an approach the bankruptcy court considered to be "flawed" because it failed to account for the fact that "state laws protecting creditors from fraudulent transfers" have been in place "since the earliest days of the Republic (having had their origins in the Statute of Elizabeth of 1571)".(83) In addition, the *Barclays* decision focused on the protection of financial markets without giving due consideration to the other purposes and objectives of Congress, most notably the "longstanding and fundamental principles that insolvent debtors cannot give away their assets to the prejudice of their creditors".(84) The *Barclays* court also appeared to accept without scrutiny the contention that avoiding the payments would "inevitably create" disruption to the markets. Yet, the *Lyondell* court noted that avoiding transfers to stockholders at the end of the asset dissipation chain "at least seemingly would not involve systemic risk concerns".(85) The *Lyondell* court emphasised that "[p] rotecting *market participants…* is not the same as protecting *markets*."(86) If Congress wished to protect the former, it "could elect to do so, but that would be a matter for express preemption, and not an implied preemption that is only judicially inferred."(87) For these reasons, the court held that Section 546(e) did not impliedly pre-empt the state law constructive fraudulent transfer claims brought by the creditor trust on behalf of individual creditors.

Although it agreed with *Tribune* on pre-emption, the court in *Lyondell* declined to follow *Tribune*'s lead with respect to the automatic stay. In a footnote, the *Lyondell* court explained that the acts similar to those that troubled the *Tribune* court with respect to the automatic stay were "underway not in this action" but in another *Lyondell* proceeding brought by the litigation trust that was parallel to, but distinct from, the one the *Lyondell* court addressed in the decision under discussion here.(88) Since the parallel proceeding might not survive because of potential deficiencies in the complaint filed there, the court in *Lyondell* declined to address the automatic stay, but preserved the rights of the parties to raise any "section 362 concerns" later.(89)

***Lyondell* decision and *Tribune* appeal**

In *Lyondell* the bankruptcy court undertook an extensive pre-emption analysis that may prove persuasive with the Second Circuit in the *Tribune* and *Barclays* appeals. The briefing has not yet concluded in the *Tribune* appeal and issues remain to be addressed, by both sides, in connection with Section 546(e).

The first set of issues pertains to the substantive differences between a bankruptcy trustee's avoidance powers under the Bankruptcy Code and the rights of individual creditors to pursue avoidance claims under state law. In crafting the safe harbour that ultimately became Section 546(e), Congress might well have perceived that an estate-funded action threatening to void an entire transaction under *Moore v Bay*(90) could pose a systemic risk far greater than any similar danger stemming from the actions of individual creditors, who, under state law, stand to recover only to the extent of their shortfall and not to the extent of the avoided transactions as a whole.(91) This might account for Congress's decision to address Section 546(e) only to the bankruptcy trustee. In *Lyondell* and *Tribune*, the claims of creditors have been combined and brought to bear on the same transactions targeted by the estate-held claims. One might ask whether the creditors' claims, when asserted in concert, pose the same systemic risk as the estate-held claims asserted by a trustee. One might also consider whether allowing the estate representative and creditors to attack the same transactions simultaneously would run counter to the policy of the Bankruptcy Code, as by interfering with the estate representative's prospects for recovering for the benefit of the creditor

constituency as a whole – a concern that moved the district court in *Tribune* to hold that creditors lack standing, as a result of the automatic stay, to pursue fraudulent transfer claims if the estate representative is pressing similar claims to attack the same transaction.(92) It will not be surprising if these issues feature prominently in the briefing to the Second Circuit that is still to come in *Tribune*.

A second issue relates to how much of a threat avoidance actions pose to market stability when the targets of those actions are former beneficial owners of the debtor's stock, who, in the words of the *Lyondell* court, are "at the very end of the asset transfer chain".(93) In its pre-emption analysis, the court in *Lyondell* suggested that statutory safe harbours are essential when market intermediaries, such as clearing agencies and depositories, are in the avoidance crosshairs, rather than beneficial owners. The court in *Lyondell* drew this distinction on the apparent understanding that the defendants targeted by the creditor trust were former beneficial owners of Lyondell stock.(94) One might ask then whether the court's pre-emption ruling would have been different had the defendants been nominees, depositories or holders in "street name", who were not beneficial owners. As it turned out, toward the end of the *Lyondell* decision, the court mentioned that the creditor trust had not been "fully successful" in carving out non-beneficial owners from its list of defendants.(95) Rather than invoking Section 546(e) pre-emption, the *Lyondell* court dismissed the claims against the non-beneficial owners on the ground that they were "mere conduits" and not "initial transferees" under Section 550 of the Bankruptcy Code and its state law analogs. Although the *Lyondell* court did not say so, it may have decided not to employ pre-emption in this particular instance because of the principle of "constitutional avoidance" (ie, if courts can dispose of a matter on non-constitutional grounds without deciding the accompanying constitutional issue, such as federal pre-emption, they should do so).(96)

Another set of issues relates to whether a bankruptcy filing permanently divests creditors of their state law fraudulent transfer claims, or whether those claims "revert" to creditors at some juncture. If the claims do not revert, then it follows that Congress had no reason to address Section 546(e) to anyone other than the bankruptcy trustee, because once a bankruptcy case is commenced, the bankruptcy trustee or estate representative is the only person authorised to pursue fraudulent transfer claims. The district court in *Tribune* suggested that fraudulent transfer claims under state law "automatically revert" to creditors because, under the Second Circuit's teaching in *Colonial Realty*, such claims are not property of the bankruptcy estate.(97) In citing *Colonial Realty* for that proposition, the district court may have climbed onto a slender branch because the Second Circuit in that case was not referring to causes of action to avoid fraudulent transfers; rather, it held that fraudulently transferred property was not part of the estate until it was recovered in an avoidance action.(98) It seems likely then that the Second Circuit will be called on to address the "reversion" issue in the *Tribune* appeal.

Comment

Given how courts have previously interpreted Section 546(e) to preclude state law claims, the *Lyondell* decision may have come as an unpleasant surprise to shareholders who participated in open transactions in public markets with no expectation that the company from which they received a payment or distribution was destined for bankruptcy. Additionally, shareholders may view the *Lyondell* decision as enabling individual creditors and their representatives to skirt Section 546(e) merely by waiting for the avoidance rights under the Bankruptcy Code to become abandoned, time-barred or assigned to a separate post-confirmation trust, and then asserting the fraudulent transfer claims of those creditors under state law. Creditors on the other hand – particularly institutional investors holding the debt securities of a company that became over-leveraged in a buy-out – may see *Lyondell* as a decision that appropriately confines Section 546(e) within its statutory limits and upholds the normal priority scheme where general creditors are supposed to come out ahead of equity holders. In these respects, a decision by the Second Circuit that puts to rest, at least within that circuit, disputes over the statutory scope and pre-emptive power of Section 546(e) will likely have ramifications for the financial markets and their participants.

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Endnotes

(1) 11 USC § 546(e). Section 546(e) provides:

> *"Notwithstanding 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." Id.

(2) See *In re Lyondell Chem Co*, 2014 WL 118036 (Bankr SDNY Jan 14 2014) (as corrected Jan 16 2014) (Gerber, J).

(3) *In re Tribune Co Fraudulent Conveyance Litig*, 499 BR 310 (SDNY 2013) (Sullivan, J).

(4) 494 BR 196 (SDNY 2013) (Rakoff, J).

(5) See *In re Tribune Co Fraudulent Conveyance Litig*, Nos 13-3992-cv(L), 13-3875-cv, 13-4178-cv, 13-4196-cv (2d Cir); *Whyte v Barclays Bank PLC*, No 13-2653-cv (2d Cir). At issue in *Barclays* is whether Section 546(g) of the Bankruptcy Code, which provides a safe harbour from avoidance for certain swap transactions, pre-empts state-law fraudulent transfer claims asserted on behalf of creditors.

(6) US Const art VI, § 2.

(7) *Lyondell Chem Co*, 2014 WL 118036, at *6 (footnotes and internal quotation marks omitted).

(8) *In re Federal-Mogul Global Inc*, 684 F3d 355, 365 (3d Cir 2012) (second alteration in original) (quoting *Medtronic, Inc v Lohr*, 518 US 470, 485-86 (1996)).

(9) *New York SMSA Ltd P'ship v Town of Clarkstown*, 612 F3d 97, 104 (2d Cir 2010) (citations and internal quotation marks omitted).

(10) See *infra* notes 65-79 and accompanying text.

(11) *Federal-Mogul Global, Inc*, 684 F3d at 365 (quoting *Medtronic, Inc v Lohr*, 518 US 470, 485 (1996)).

(12) *Id* (alteration in original) (quoting *Farina v Nokia Inc*, 625 F3d 97, 117 (3d Cir 2010)).

(13) In a Chapter 11 reorganisation case, a "debtor in possession" normally performs the functions and duties of a trustee under the Bankruptcy Code. See 11 USC § 1107 (a). Additionally, in some jurisdictions, an official committee of unsecured creditors appointed in a Chapter 11 case may obtain leave of court to step into the shoes of the debtor-in-possession and prosecute fraudulent transfer claims derivatively on behalf of the estate. See, eg, *In re Smart World Techs, LLC*, 423 F3d 166, 176 (2d Cir 2005). Furthermore, a plan of reorganisation may provide for the "retention and enforcement by the debtor, by the trustee, or by a *representative of the estate* appointed for such purpose" of any claim or interest belonging to the debtor or the estate, such as a fraudulent transfer claim. 11 USC § 1123(b)(3)(B) (emphasis added).

(14) 11 USC § 546(e).

(15) *Id*; see also *id* § 741(8) (defining 'settlement payment'); *Contemporary Indus Corp v Frost*, 564 F3d 981, 985 (8th Cir 2009).

(16) 5 *Collier on Bankruptcy* ¶ 546.06[2], at 546-48 (Alan N Resnick & Henry J Sommer, eds, 16th ed 2012).

(17) *In re Adler, Coleman Clearing Corp*, 263 BR 406, 477 (SDNY 2001).

(18) *Id* (quoting HR Rep 97-420, at 1 (1982), *reprinted in* 1982 USCCAN 583, 583).

(19) *In re Enron Creditors Recovery Corp*, 651 F3d 329, 334 (2d Cir 2011) (quoting *In re Resorts Int'l, Inc*, 181 F3d 505, 515 (3d Cir 1999)).

(20) See 11 USC § 546(e) (providing safe harbour from avoidance claims, "except [those claims] under section 548(a)(1)(A) of this title").

(21) See *id* § 548(a)(1)(A).

(22) See *id* § 548(a)(1).

(23) See, eg, Uniform Fraudulent Transfer Act § 9(a), (b). Generally, the reach-back period under New York law is six years. *Island Holding, LLC v O'Brien*, 775 NYS2d 72, 74 (NY App Div 2004).

(24) 11 USC § 544(b)(1).

(25) *In re Norstan Apparel Shops, Inc*, 367 BR 68, 75 (Bankr EDNY 2007) (citing, among

other cases, *Resorts Int'l*, 181 F3d at 515-16; *In re Hamilton Taft & Co*, 114 F3d 991, 993 (9th Cir 1997); *In re Kaiser Steel Corp*, 913 F2d 846, 850 (10th Cir 1990)).

(26) See, eg, *In re QSI Holdings, Inc*, 571 F3d 545, 547, 549-50 (6th Cir 2009); *Contemporary Indus Corp*, 564 F3d at 985-87. Notwithstanding the aforementioned cases cited, courts are split on this issue. See generally 5 *Collier on Bankruptcy* ¶ 546.06[2][b][i], at 546-53 (Alan N Resnick & Henry J Sommer, eds, 16th ed 2012) (stating that "there is much disagreement over whether section 546(e) applies to both public and nonpublic securities transactions") (citing cases).

(27) See *Contemporary Indus Corp*, 564 F3d at 988; *US Bank NA v Verizon Commc'ns, Inc*, 892 F Supp 2d 805, 824 (ND Tex 2012); *In re Hechinger Inv Co of Del*, 274 BR 71, 96-98 (D Del 2002).

(28) *Contemporary Indus Corp*, 564 F3d at 988; *US Bank NA*, 892 F Supp 2d at 824; *Hechinger Inv Co*, 274 BR at 96-98.

(29) 11 USC § 546(e).

(30) Third Amended Complaint ¶¶ 6, 62, 66, & 110, *Deutsche Bank Trust Co Am v Adaly Opportunity Fund TD Securities Inc*, 11-cv-04784 (SDNY Oct 9, 2012), Doc 704; Second Amended Complaint ¶¶ 13, 35-37, *Niese v AllianceBernstein LP*, 11-cv-04538 (SDNY Dec 20, 2011), Doc 204.

(31) Individual Creditor Plaintiffs' Memorandum of Law in Opposition to Defendants' Joint Phase One Motion to Dismiss the Individual Creditor Actions with Prejudice Pursuant to Federal Rule of Civil Procedure 12(b)(6), at 3-4, *In re Tribune Co Fraudulent Conveyance Litig*, 11-md-2296 (SDNY Dec 21, 2012), Doc 2086 (hereinafter, "Plaintiffs' Mem of Law"); Memorandum of Law in Support of Defendants' Joint Phase One Motion to Dismiss the Individual Creditor Actions with Prejudice Pursuant to Federal Rule of Civil Procedure 12(b)(6), at 4-5, *In re Tribune Co Fraudulent Conveyance Litig*, 11-md-2296 (SDNY Nov 6 2012), Doc 1671 (hereinafter, "Defs' Mem of Law").

(32) Plaintiffs' Mem of Law, *supra* note 31, at 4; Defs' Mem of Law, *supra* note 31, at 6-7.

(33) Defs' Mem of Law, *supra* note 31, at 7.

(34) *Id* at 8.

(35) See *Tribune Co Fraudulent Conveyance Litig*, 499 BR at 320.

(36) *Id* at 316 (quoting *Hartford Underwriters Ins Co v Union Planters Bank, NA*, 530 US 1, 6 (2000)).

(37) *Id* at 318.

(38) *Id*.

(39) *Id* (footnote omitted).

(40) *Id* at 318-19 (quoting 11 USC § 544(b)(2)) (second alteration in original). Section 544(b)(2) was added to the Bankruptcy Code by the Bankruptcy-Religious Liberty and Charitable Donation Protection Act of 1998, Pub L 105-183, 112 Stat 517.

(41) *Tribune Co Fraudulent Conveyance Litig*, 499 BR at 319.

(42) *Id* at 318.

(43) *Id*.

(44) 494 BR 196 (SDNY 2013) (Rakoff, J).

(45) *Id* at 198.

(46) *Id*; see also *id* at 199 ("Barclays contends, and the Trustee does not dispute, that the [challenged transfer] qualifies as a swap transaction benefiting from the safe harbor of section 546(g)").

(47) See *id* at 199-200.

(48) *Tribune Co Fraudulent Conveyance Litig*, 499 BR at 319.

(49) *Id*.

(50) See *id* at 312-13 & n4.

(51) *Id* at 313, 323-25.

(52) *Id* at 325.

(53) Brief and Special Appendix for Plaintiffs-Appellants-Cross-Appellees, *In re Tribune Co Fraudulent Conveyance Litig*, 13-3992-cv(L), 2013 WL 6823523, at *5 (2d Cir Dec 20 2013).

(54) *Id* at *4-5.

(55) Complaint ¶¶ 1, 351, 396-400, & 401(i), *Weisfelner v Morgan Stanley & Co, Inc*, 651829/2010 (NY Sup Ct Oct 22, 2010) (incorporated in Ex A to Notice of Removal, *In re Lyondell Chem Co*, 10-4609 (Bankr SDNY Dec 1 2010), Doc 1-3).

(56) Memorandum of Law in Support of Defendants' Motion to Dismiss the Complaint, at 8-12, *Weisfelner v Morgan Stanley & Co, Inc (In re Lyondell Chem Co)*, 10-4609 (Bankr SDNY Jan 11 2011), Doc 72.

(57) *Id* at 13-14.

(58) See *Lyondell Chem Co*, 2014 WL 118036, at *34. In the same decision, the bankruptcy court granted the motions in part on other issues that are not covered in this article.

(59) *Id* at *5.

(60) *Id* (quoting 11 USC § 546(e)).

(61) *Id* at *6.

(62) *Id*.

(63) *Id* at *8.

(64) *Id* at *9-10.

(65) *Id* at *10 (internal quotation marks omitted).

(66) *Id*.

(67) *Id* (internal quotation marks omitted).

(68) *Id* (quoting *In re Methyl Tertiary Butyl Ether ("MTBE") Prods Liab Litig*, 725 F3d 65, 101-02 (2d Cir 2013)).

(69) *Id* at *12 (quoting *Tribune Co Fraudulent Conveyance Litig*, 499 BR at 318-19).

(70) *Id* at *14 (quoting 1 *Collier on Bankruptcy* ¶ 1.05[5] (Alan N Resnick & Henry J Sommer, eds, 16th ed 2010)).

(71) *Id* (quoting *Adler, Coleman Clearing Corp*, 263 BR at 463).

(72) *Id* at *15.

(73) *Id* at *16.

(74) *Id*.

(75) *Id*.

(76) *Id* at *16-18.

(77) *Id* at *19.

(78) *Id* at *18.

(79) *Id* at *19 (internal quotation marks omitted).

(80) *Id* at *20.

(81) See *id* at *23 n.148.

(82) Brief for *Amici Curiae* Defendants in the Tribune, Lyondell, and Boston Generating Fraudulent-Transfer Cases, *Whyte v Barclays Bank PLC*, 13-2653-cv, 2013 WL 5705641, at *13 (2d Cir Oct 10 2013).

(83) *Lyondell Chem Co*, 2014 WL 118036, at *21.

(84) *Id* at *22.

(85) *Id*.

(86) *Id*.

(87) *Id*.

(88) *Id* at *23 n148.

(89) *Id.*

(90) 284 US 4, 5 (1931).

(91) See, eg, *In re Tronox Inc*, 464 BR 606, 615-16 (Bankr SDNY 2012) ("Section 544(b) of the Bankruptcy Code... allow[s] a trustee to avoid a fraudulent transfer without regard to the size of the claim of the creditor whose rights and powers the trustee was asserting," while "state fraudulent transfer laws... provide that the creditor in a fraudulent transfer action may not recover more than the amount necessary to satisfy the creditor's [own] claim." (internal quotation marks omitted)).

(92) *Tribune Co Fraudulent Conveyance Litig*, 499 BR at 324-25 ("While the trustee acts, it cuts off the claims of creditors in order to seek a fair, orderly, and comprehensive resolution of the debtor's financial affairs so that, as much as it is possible, creditors are made whole").

(93) *Lyondell Chem Co*, 2014 WL 118036, at *18.

(94) See *id* at *19.

(95) *Id* at *26.

(96) See, eg, *Columbia Venture, LLC v Dewberry & Davis, LLC*, 604 F3d 824, 828 (4th Cir 2010) ("We have held that federal preemption of state law is a constitutional question because it is premised on the Supremacy Clause of the United States Constitution, and when a party provides alternative independent state law grounds for disposing of a case, courts should not decide the constitutional question of preemption before considering the state law grounds").

(97) *Tribune Co Fraudulent Conveyance Litig*, 499 BR at 321-22 (citing *In re Colonial Realty Co*, 980 F2d 125, 131 (2d Cir 1991)).

(98) *Colonial Realty Co*, 980 F2d at 130-31.

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