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# Ever-Expanding Safe Harbor Leaves Creditors' Claims Stranded at Sea

***Second Circuit holds that Bankruptcy Code preempts creditors' state law constructive fraud claims.***

On March 29, 2016, the Second Circuit issued its opinion in *In re Tribune Company Fraudulent Conveyance Litig.*,[1] unanimously holding that creditors' state law, constructive fraudulent transfer (SLCFT) claims were preempted and extinguished by the Bankruptcy Code.[2] The case, which involved creditors' attempts to claw back payments to former shareholders of Tribune Media Company (Tribune) in connection with a leveraged buyout (LBO), settled a conflict among the Second Circuit's lower courts regarding the scope of the safe harbor under section 546(e) of the Bankruptcy Code. The decision in *Tribune* is the latest in a line of cases that have expanded the scope of section 546(e) and importantly, the holding effectively marks the end of the line for creditors seeking to circumvent the safe harbors under section 546 and assert their own SLCFT claims.

## Section 546(e)'s Safe Harbor

The Bankruptcy Code allows a trustee to avoid and recover certain pre-petition transfers made by a debtor. These avoidable transfers include preferences and fraudulent conveyances under the Bankruptcy Code, as well as fraudulent conveyances avoidable by creditors under state law.

Section 546(e) of the Bankruptcy Code provides a safe harbor from the trustee's avoidance efforts by protecting certain payments from this avoidance power. Namely, the safe harbor protects "margin payments," "settlement payments" and other transfers arising "in connection with" a securities contract, commodity contract or forward contract that involved specific financial intermediaries, which include statutorily defined financial institutions and financial participants. This provision was enacted to "minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries."[3]

Courts have applied the broad language of section 546(e) to further Congressional intent to prevent one large bankruptcy from creating a ripple effect throughout the securities industry. However, this broad language and the courts' subsequent interpretation has led to the application of 546(e) to cases to which Congress arguably never intended the statute to reach. For instance, the malleable language of "in connection with a securities contract," once thought to have a narrow definition, has been stretched to encompass LBOs of privately held companies[4] and payments beyond those "commonly used" in the securities trade.[5]

Reacting to courts' increasingly broad interpretations of section 546(e), in several cases parties have sought to avoid the application of section 546(e) by focusing on SLCFT claims that, prior to the bankruptcy, constitute creditors' property. The novel question that arose in *Tribune* was whether the Second Circuit would continue its historically broad construction of section 546(e) to bar creditors, or their assignees, from asserting constructive fraud claims just as trustees or debtors-in-possession are barred from bringing such claims.

## Factual and Procedural Background

In 2007, Tribune was acquired pursuant to an LBO transaction. As a part of that transaction, Tribune borrowed US$11 billion secured by its assets, paired with US$315 million in sponsor equity, to refinance some of its pre-existing bank debt and to cash out Tribune's shareholders for over US$8 billion. To execute this LBO, Tribune transferred the funds through a financial intermediary who then cashed out shareholders in exchange for their shares, which were returned to Tribune. Subsequently, Tribune filed for bankruptcy in 2008 with debt and liabilities exceeding its assets by more than US$3 billion.

In November 2010, the Official Committee of Unsecured Creditors commenced an actual fraudulent conveyance action against the former Tribune shareholders and others alleged to have benefitted from the LBO. The following year, two subsets of unsecured creditors (the Creditors), in their individual capacities, filed SLCFT claims in hundreds of federal and state lawsuits seeking recovery of money the former shareholders had received. The Creditors brought the claims in their individual capacity because the estate representatives were barred from bringing such claims as "trustee" under section 546(e). The lawsuits were consolidated in the U.S. District Court for the Southern District of New York.

In September 2013, the District Court dismissed the individual Creditors' claims on the grounds that the Bankruptcy Code's automatic stay provision, section 362, deprived the Creditors of statutory standing to pursue their claims, so long as the estate representatives challenged the same transfers under an intentional fraud theory.[6] The District Court did, however, reject the argument that the Creditors' claims were prohibited by section 546(e) because that statutory provision (i) only applied to the bankruptcy trustee, and (ii) Congress declined to extend section 546(e) to SLCFT claims brought by creditors.

## Appeal to the Second Circuit

### Addressing the Split in the Lower Courts

The District Court's ruling in *Tribune* contributed to a growing split among the lower courts as to whether section 546(e) prohibited individual creditors, or their assignees, from bringing state law claims. In less than a year's time, the Southern District handed down seemingly conflicting opinions — holding in *Lyondell*[7] that section 546(e) did not bar creditors from asserting SLCFT claims, while concluding in *Barclays*[8] that an analogous safe harbor related to swap transactions, section 546(g), did "impliedly preempt state-law fraudulent conveyance actions."

These lower court cases represented creditors' creative efforts to avoid the Second Circuit's historically broad reading of section 546(e). The appeals in *Tribune* and *Barclays* positioned these approaches directly in front of the Second Circuit and raised questions concerning preemption and the outer limits of section 546(e).

### Second Circuit Decision in *Tribune*

The Second Circuit in *Tribune* addressed two issues: (i) whether the automatic stay barred the Creditors from bringing their SLCFT claims and (ii) if not, whether section 546(e) preempted the Creditors' SLCFT claims. The Court unanimously affirmed the dismissal of the individual Creditors' claims, holding that while section 362 of the Bankruptcy Code did not deprive the Creditors of standing to pursue their claims, section 546(e) of the Bankruptcy Code preempted and extinguished the Creditors' SLCFT claims.

On appeal, the Creditors had argued that the plain language of section 546(e) bars only claims brought by a trustee, not claims brought by a creditor or its assignee. The Creditors contended that, before a bankruptcy commences, a fraudulent conveyance action belongs to individual creditors rather than to the debtor and that upon the bankruptcy filing, the role and responsibility of the trustee is to "step into the shoes of a creditor under state law and avoid any transfers such a creditor could have avoided."[9] However, because in the instant case the debtor (or the Official Committee of Unsecured Creditors on its behalf) failed to bring a constructive fraudulent conveyance action within the two-year statute of limitations period set forth under section 546(a)(1)(A), the Creditors argued that such claims reverted back to the Creditors who could therefore pursue their own SLCFT actions.

The Second Circuit quickly found that the automatic stay did not impact the Creditors' statutory standing to bring claims in the instant case because the Creditors had obtained stay relief through three separate court orders and through the language of the confirmed reorganization plan itself.

Following its brief discussion of the automatic stay, the Second Circuit next analyzed whether the safe harbor provisions of section 546(e) barred the Creditors' SLCFT claims. Judge Ralph K. Winter, Jr. noted that section 546(e) is ambiguous as to whether the Creditors may assert a state law claim, as the language of the statute only expressly precludes claims by a trustee or representative of the estate. However, the Court reasoned that a preemptive effect may still be implied even if the ambiguous language does not expressly provide a preclusive effect.[10]

The Second Circuit explained that once Tribune entered bankruptcy, the Creditors' avoidance claims were vested in the appointed trustee and representatives of the estate, to the exclusion of the Creditors. For these avoidance actions to revert back to individual creditors would require a "matter of grace" granted under federal law. However, the Second Circuit's analysis of the legislative purpose of section 546(e) revealed that allowing these state law claims to be sent back for individual creditors to pursue would ultimately hinder the intended purpose of section 546(e).

Because preemption, express or implied, is a matter of Congressional intent, the Second Circuit looked to the purpose of, and policies behind, the enactment of the safe harbors to determine whether the Bankruptcy Code preempted the Creditors' state law claims. Judge Winter opined that a broad application of the safe harbors would serve the intended purposes and policies of the statute, namely the need for certainty, speed and stability of the financial markets by minimizing the impact of a bankruptcy filing on certain types of financial transactions. Given the clear Congressional intent behind section 546(e), the Second Circuit concluded that allowing individual creditors to pursue state law claims and thereby unwind transactions that were otherwise protected by the federal safe harbors fundamentally conflicted with the purpose of section 546(e), however "narrow or broad." Judge Winter remarked that "[u]nwinding settled securities transactions by claims [of individual creditors] would seriously undermine – a substantial understatement – markets in which certainty, speed, finality and stability are necessary to attract capital." Preventing a trustee from unwinding transactions but allowing an individual creditor to do so even later would likewise hinder the goals of finality and stability that Congress intended.

Because of the conflict between the Bankruptcy Code (a federal statute) and applicable state law, the Court concluded that section 546(e) preempts state law and bars individual creditors from pursuing SLCFT claims to unwind transactions that the safe harbors were intended to protect.

## Implications

The Second Circuit's holding in *Tribune* has numerous potential implications for creditors. First, an individual creditor's SLCFT claims against a shareholder or other beneficiary in an LBO transaction are essentially extinguished by the Bankruptcy Code's preemption of those claims, at least to the extent that such claims fall within the ambit of the safe harbors of sections 546(e), (f) and (g) — as those claims clearly do in the Second Circuit. As a result, the tactics creditors have employed over the years to circumvent the language of the safe harbors, whether through assigning a creditor's claim to a litigation trust or having it brought by an individual creditor, are no longer viable options. The *Tribune* decision represents a victory for those beneficiaries of an LBO.

Relatedly, the decision in *Tribune* must be considered in the context of the ever-expanding interpretation and scope of sections 546(e), (f) and (g). Significantly, the Second Circuit did not find that the Creditors' SLCFT claims were on ice until the running of the limitations period under the Bankruptcy Code. Rather, the Second Circuit held that the claims were preempted and extinguished — that is, because of the policies and purposes underlying the section 546 safe harbors, the Creditors would never have a chance to bring their claims once the bankruptcy case was commenced and not dismissed.

Creditors should carefully watch section 546(e) cases that make their way through other circuit courts. While undoubtedly the Second Circuit has an expansive view of section 546(e) and its preemptive authority after the *Tribune* decision, other circuits may not be as willing to push the contours and reach of section 546(e) quite as far as the Second Circuit has. Indeed, creditors may still have to navigate rough seas in the world of safe harbors.

Finally, the *Tribune* decision arguably has consequences beyond the safe harbor provisions of section 546. The opinion begins with a very broad statement of preemption — namely, that creditors' SLCFT claims are broadly preempted by the bankruptcy itself, without reference to section 546. For example, the opinion states that a debtor's disposition of its fraudulent conveyance claims under sections 544 and 548 "extinguishes the right of creditors to bring state law, fraudulent conveyance claims."[11] However, the opinion subsequently retreats from such a broad statement of the law by stating that the decision does not "affect[] fraudulent conveyance actions brought by creditors whose claims are not subject to Section 546(e)."[12] Nonetheless, due to the sweeping nature of certain portions of the opinion, the *Tribune* decision may have broader implications for the treatment and prosecution of creditor claims that are arguably derivative in nature.

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**Endnotes**

1 Case 13-3992, Doc. 356-1 (2d Cir. Mar. 29, 2016).

2 The Second Circuit simultaneously applied the same ruling in a case involving Bankruptcy Code section 546(g). *Whyte v. Barclays Bank PLC*, No 13-2653-CV (2d Cir. March 24, 2016).

3 *In re Madoff Inv. Sec., LLC*, 773 F.3d 411, 416 (2d Cir. 2014). Sections 546(f) and (g) provide similar protection for payments under repurchase agreements and swap agreements, respectively.

4 *Contemporary Industries Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009).

5 *In re Enron Creditors Recovery Corp. v. Alfa*, *S.A.B.*, 651 F.3d 329 (2d Cir. 2011).

6 *In re Tribune Co. Fraudulent Conveyance Litig.*, 499 B.R. 310, 325 (S.D.N.Y. 2013).

7 *In re Lyondell Chem. Co.*, 503 B.R. 348, 365, 372-73 (Bankr. S.D.N.Y. 2014).

8 *Whyte v. Barclays Bank PLC (In re SemCrude, L.P.)*, 494 B.R. 196, 201 (S.D.N.Y. 2013).

9 *In re Tribune Co. Fraudulent Conveyance Litig.*, Case 13-3992, Doc. 356-1 at 26.

10 In response to the Creditors' notion that a presumption against preemption should apply, the Second Circuit stated that the Bankruptcy Code constitutes a wholesale preemption of state laws regarding the rights of creditors.

11 *Id.* at 21.

12 *Id.* at 38.