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Second Circuit Rules that Bankruptcy Safe Harbors Preempt Creditors' State Law Causes of Action

On March 29, 2016, the Second Circuit addressed the breadth and application of the Bankruptcy Code's safe harbor provisions in an opinion that applied to two cases before it. The court analyzed whether: (i) the Bankruptcy Code's safe harbor provisions preempt individual creditors' state law fraudulent conveyance claims; and (ii) the automatic stay bars creditors from asserting such claims while the trustee is actively pursuing similar claims under the Bankruptcy Code. In *In re Tribune Co. Fraudulent Conveyance Litigation*, -- F.3d --, 2016 WL 1226871 (2d Cir. March 29, 2016) ("*Tribune*"), the Second Circuit concluded in an extensive opinion that creditors' state law fraudulent conveyance claims could not proceed because the Bankruptcy Code's safe harbor provisions preempted the pursuit of those claims, even though the creditors had validly obtained relief from the automatic stay to bring them.¹

Background

Tribune was the largest privately-held media and entertainment company in the United States when it filed for bankruptcy in 2008 shortly after a massive leveraged buy-out (LBO). During the case, the Bankruptcy Court authorized the official committee of unsecured creditors to prosecute avoidance actions for the benefit of creditors.² In that capacity, the committee filed a lawsuit to claw back some \$8 billion of transfers made by Tribune in the LBO as actual fraudulent conveyances under section 548 of the Bankruptcy Code.

The committee had limited its challenge of the LBO transfers to actual fraud claims in light of the Bankruptcy Code's so-called safe harbor provisions. Those provisions prevent a trustee (or other entity acting with the trustee's authority, like a committee) from challenging a wide range of financial transactions, such as the LBO transfers at issue, unless they are the result of actual fraud. The committee thus did not challenge the LBO transfers as constructive fraudulent conveyances. Thereafter, a number of

¹ Contemporaneously with the issuance of the opinion, the Second Circuit issued a summary order in *Whyte v. Barclays Bank PLC*, 2016 WL 1138642 (2d Cir. March 24, 2016) that affirmed, based on the reasoning of *Tribune*, a lower court's conclusion that the safe harbors barred a litigation trustee, acting in its capacity as the assignee of creditors' claims, from asserting those creditors' state law avoidance claims.

² Specifically, the committee was authorized to stand in the shoes of the trustee and bring claims under either (i) section 548 of the Bankruptcy Code, which creates federal causes of action, or (ii) section 544 of the Bankruptcy Code, which gives the trustee the ability to avoid transfers or obligations that may be avoided by creditors under applicable nonbankruptcy law.

individual creditors proposed to challenge the LBO transfers as constructive fraudulent conveyances by bringing their own claims under state law. Once the bankruptcy statute of limitations for the committee to bring such claims expired, the Bankruptcy Court agreed to conditionally lift the automatic stay to permit the creditor suits to proceed, thus avoiding the lapse of the creditors' claims under state law statutes of limitations. Tribune's confirmed chapter 11 plan later affirmed that creditors could pursue "any and all LBO-related causes of action arising under state law", except for those claims asserted by the committee. Based on these lift-stay orders and the terms of the plan, starting in 2011, several individual creditors proceeded with their state law constructive fraud claims related to the LBO.

In September 2013, the District Court for the Southern District of New York dismissed the creditors' consolidated lawsuits, concluding that the automatic stay prevented the creditors from pursuing their claims while the committee's avoidance litigation was ongoing. Specifically, the District Court found that allowing the creditors to challenge the LBO transfers when the committee was already challenging those same transfers – albeit under a different avoidance theory – would undermine a primary purpose of the Bankruptcy Code's automatic stay provision, the avoidance of duplicative, piecemeal litigation. *In re Tribune Co. Fraudulent Conveyance Litigation*, 499 B.R. 310 (S.D.N.Y. 2013). In reaching this conclusion, the District Court also determined that the Bankruptcy Code's safe harbor provisions would not have otherwise barred the creditors' claims. Appeals of these rulings to the Second Circuit followed.

Section 362 & Standing to Sue

The Second Circuit first analyzed the automatic stay's impact on the creditor lawsuits. Under section 362(a)(1) of the Bankruptcy Code, filing a bankruptcy case automatically stays any action or proceeding against the debtor and case law confirms that the stay extends to fraudulent conveyance actions. Reversing the District Court, the Circuit Court concluded that the stay did not impact the creditor lawsuits in this instance. It briefly noted that the stay can be lifted for "cause" and that the creditors had validly obtained such relief through at least three separate bankruptcy court orders. It also referenced the language of the confirmed chapter 11 plan, which expressly allowed creditors to pursue such claims. 2016 WL 1226871, at *4-5.

Section 546(e) & Preemption

The Second Circuit next analyzed whether the Bankruptcy Code's safe harbor provisions barred the creditors' causes of action. As noted above, section 546(e) of the Bankruptcy Code and the related safe harbor provisions protect a wide range of financial transactions from avoidance by *the trustee*, unless they are the result of actual fraud. *See e.g.* 11 U.S.C. § 546(e) ("the trustee may not avoid . . ."). The Circuit Court acknowledged that, on its face, the statute does not appear to apply to individual creditors' state law claims. 2016 WL 1226871, at *5. Nevertheless, after extensively reviewing the Bankruptcy Code's safe

harbor and avoidance provisions and carefully considering the creditors' legal theory, it held that section 546(e) was ambiguous concerning a creditor's ability to assert a state law claim. *Id.* at *15.

Accordingly, the Second Circuit turned to whether the federal safe harbor provisions implicitly preempt state law. Under the implied preemption doctrine, state laws are preempted if they conflict with a federal statute. *Id.* at *6. A conflict exists where the state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Id.* (internal citations omitted). The Circuit Court's preemption analysis thus focused on the purpose of, and policies behind, the safe harbors.

As the Second Circuit explained, the safe harbors ensure the stability of the financial markets by minimizing the impact of a bankruptcy filing by a key financial player. To accomplish that goal, the safe harbors protect a broad range of settled financial transactions from being unwound in bankruptcy. In so doing, the safe harbors promote finality and certainty for investors generally. *Id.* at *15. Consistent with these goals, the provisions are broadly drafted, and courts, including the Second Circuit, have generally applied them as written, even in circumstances where the transaction at issue arguably does not impact the financial markets. *See e.g. Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329 (2d Cir. 2011) (rejecting proposed limitation on protections provided by section 546(e)). Confirming that "no conflict" exists between the statute's broad language and its intended purpose, in *Tribune*, the Second Circuit noted that "[s]uch broad language is intended to protect the process or market from the entire genre of harms" 2016 WL 1226871, at *16. Moreover, the Circuit Court found that this goal is paramount, even if it limits creditor rights or comes at the expense of other priorities in bankruptcy. *Id.* at *19.

Having identified a clear congressional purpose, the Second Circuit determined that allowing the individual creditors to pursue state law causes of action and thereby unwind transfers that were otherwise protected by the safe harbors fundamentally conflicted with "[e]very congressional purpose reflected in Section 546(e), however narrow or broad . . ." *Id.* at *15. Congress intended to immunize categories of financial transactions from challenge, lest unwinding settled financial transactions jeopardize the stability of the financial markets. Logically, then, risks to the market exist regardless of whether it is a trustee or individual creditors seeking to unwind the transactions. In fact, the Circuit Court noted that allowing this sort of creditor action to proceed would actually increase market uncertainty, since the creditors could only assert their state law causes of action after the Bankruptcy Code's two year statute of limitations. *Id.* As the Court succinctly stated, "the idea of preventing a trustee from unwinding specified transactions while allowing creditors to do so, but only later, is a policy in a fruitless search of a logical rationale." *Id.*

Having found the requisite conflict between the federal statute and applicable state law, the Second Circuit concluded that section 546(e) preempts state law, thereby barring creditors from pursuing state law constructive fraudulent conveyance claims to unwind transactions that the safe harbors were intended to protect.

Conclusion

With the *Tribune* opinion and order and the related *Whyte* order, the Second Circuit reaffirms its view that the Bankruptcy Code's safe harbor provisions broadly protect those under their ambit, and that those protections may not be curtailed through inventive legal arguments or theories. In this regard, the opinion and order are fully consistent with the Second Circuit's previous decisions concerning the breadth and scope of the safe harbors, and parties involved in bankruptcy proceedings within the Second Circuit should treat with caution any effort to limit the scope of the safe harbors' protections.³

³ The *Tribune* decision also devoted substantial attention to whether state law fraudulent conveyance claims constitute property of the estate transferred to the trustee upon a bankruptcy filing and, if so, whether that property reverts to individual creditors if the trustee fails to assert the claims during the applicable time period. Ultimately, the Second Circuit concluded that it need not resolve these issues to render its decision, and its commentary on these matters is thus dicta.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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