

Insolvency and Restructuring Update

The Lyondell Decision and Implications for Lawsuits Seeking to Claw-Back Payments to Shareholders in LBO Transactions

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On January 14, 2014, U.S. Bankruptcy Judge Robert E. Gerber of the Southern District of New York issued a decision with potential implications for the interpretation of Section 546(e) of the Bankruptcy Code, the statute that protects “settlement payments” in securities transactions from claims for constructive fraudulent transfer and preference actions. In a 65-page opinion, Judge Gerber denied a motion – based on Section 546(e) – to dismiss state-law constructive fraudulent conveyance claims brought by a trust seeking to claw back payments that were made to former shareholders of LyondellBasell Industries (“Lyondell”) in a leveraged buyout transaction (“LBO”). While Judge Gerber granted in part and denied in part motions to dismiss on other bases, he rejected the defendants’ principal argument that Section 546(e) bars such claims. The Court found that Section 546(e) only bars claims brought by a bankruptcy estate “trustee” – and does not preempt individual creditors or a trust acting on their behalf from bringing state-law constructive fraudulent conveyance claims. The Court endorsed the recent decision in the ongoing *Tribune Company Fraudulent Conveyance Litigation* where Judge Richard Sullivan of the Southern District of New York reached a similar conclusion. The *Tribune* decision has been appealed to the U.S. Court of Appeals for the Second Circuit, where oral argument will occur together with the appeal of *Whyte v. Barclays Bank PLC*, where Judge Jed. S. Rakoff of the Southern District of New York dismissed similar claims brought by a litigation trust created under a reorganization plan in the *SemGroup* bankruptcy matter. As a practical matter, the viability of the Lyondell decision will likely rise or fall based on the Second Circuit’s conclusions in *Tribune* and *Whyte*. The case is *Weisfelner v. Fund 1 (In re Lyondell Chem. Co.)*, No. 10-4609 (REG), 2014 WL 118036 (Bankr. S.D.N.Y. Jan. 14, 2014).

The Creditors’ Trust

Lyondell filed for Chapter 11 bankruptcy protection in January 2009, and emerged from bankruptcy in April 2010. Lyondell’s plan of reorganization (the “Plan”) provided that the estate would abandon its right to pursue state-law fraudulent transfer claims on behalf of individual creditors because such claims would almost certainly have been barred by Section 546(e) had they been asserted by an estate representative. Instead, a so-called “Creditors’ Trust” was created, and individual creditors assigned their claims to the trust for pursuit on their behalf. Following Lyondell’s emergence from bankruptcy, the Creditors Trust filed suit against numerous financial institutions and other defendants in New York Supreme Court. The complaint alleged that some \$12.5 billion in payments to former shareholders of Lyondell constituted fraudulent transfers under state law because no reasonable value was given in return, and Lyondell was insolvent at the time. Certain defendants removed the case to district court, and the matter was referred to Judge Gerber, who had handled the *Lyondell* bankruptcy proceedings.

The Motions to Dismiss

A group of defendants filed motions to dismiss on several bases. First, the movants argued that such fraudulent transfer claims are preempted under Section 546(e) of the bankruptcy code, and that to allow such claims to proceed would frustrate Congress’ intent when it barred the bankruptcy estate in bringing a lawsuit on this basis. The movants also argued that the Creditors’ Trust could not recover because the transferred funds were not property of the debtors, and that many of the defendants were “mere conduits”

who did not retain the proceeds themselves. Finally, the movants argued that the Creditors' Trust lacked standing to sue since some of the individual creditors on whose behalf the trust was acting were also lenders in the LBO transaction and thus could not attack it now.¹

The Court Rejects the Section 546(e) Argument

The Court held that the plain language of Section 546(e) only bars avoidance claims brought by a bankruptcy "trustee" – an estate representative – and not state-law claims brought by individual creditors. The Court likewise held that there was no basis to conclude that such claims were "preempted" by federal law. Although the legislative history of Section 546(e) discusses the need to protect the stability of the nation's financial markets, Judge Gerber – endorsing the *Tribune* decision – noted that there are many competing rationales that underpin the bankruptcy code's provisions, and he found it significant that Congress had expressly preempted such claims with respect to charitable contributions, but not other transfers. Ultimately, Judge Gerber wrote, it "is the job of Congress" to draw a clear line between transfers that are protected and those that are not.

Moreover, the Court rejected the rationale of the district court in *Whyte*, which had dismissed state-law fraudulent transfer claims brought by a trustee who was acting both as an estate representative and as an assignee of claims from individual creditors. Judge Gerber not only distinguished *Whyte* on its facts (the trustee there was "wearing two hats"), he opined that the decision was "flawed" in that it should have applied a presumption against preemption given that state-law fraudulent transfer statutes long predate Section 546(e). Judge Gerber also observed that the *Whyte* court failed to consider other Congressional objectives beyond the protection of the securities markets or to appreciate a distinction between "market participants" and the market itself.

Other Grounds for Dismissal

The Court rejected the defendants' argument that the funds at issue were never property of the debtors (and thus not subject to claw-back), holding that the LBO can be viewed as a single, "collapsed" transaction with the proceeds viewed as property of the debtors. However, the Court granted the motion to dismiss as to "mere conduit" defendants who did not retain the shareholder proceeds but instead passed them on to others. Finally, the Court concluded that state-law fraudulent transfer claims could not be brought on behalf of LBO lenders who were also creditors, since those parties had "ratified" the transaction.

Future Implications

Lyondell is one of several cases where creditors are attempting to avoid the reach of Section 546(e). The decision is notable in that it endorses the analysis of the *Tribune* decision and rejects the reasoning of the *Whyte* decision. *Tribune* and *Whyte* will be argued before the Second Circuit later this year, before the same panel on the same day. The Second Circuit's decision in these cases will presumably dictate whether the *Lyondell* decision will remain viable on appeal. If left to stand, *Lyondell* and *Tribune* make it likely that individual creditors will continue to assert state-law constructive fraudulent transfer claims that the bankruptcy code would preclude an estate representative from asserting.

¹ The movants also sought dismissal of the intentional fraud claims brought by the Creditors' Trust. The Court granted the motion to dismiss on this basis because of pleading deficiencies in the complaint, although the plaintiff was granted the opportunity to re-plead.

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