

## Second Circuit Says Section 546 of Bankruptcy Code Preempts State Law Constructive Fraud Claims

March 30, 2016

### Unanimous panel affirms dismissals of two actions brought by creditors seeking to avoid transactions through an end run around Section 546

In a final opinion dated March 29, 2016, the Second Circuit unanimously held that in circumstances where Section 546 of the Bankruptcy Code bars estate representatives from asserting constructive fraudulent conveyance claims under state law, the statute likewise prevents individual creditors from bringing those claims after the estate's time to do so expires. The Circuit's ruling in *In re: Tribune Company Fraudulent Conveyance Litigation*, No. 13-3992, and summary order in related case *Whyte v. Barclays Bank*, 13-2653, were the first decisions from a circuit court on the issue and settled a conflict among its lower courts. In a 53-page decision, the Circuit rejected the argument that the text of the statute only bars constructive fraud claims brought by a trustee or other estate representative, instead holding that the doctrine of implied preemption protects settlement payments and swap transactions from constructive fraud claims brought by any party. The decision may put an end to recent attempts by creditors to circumvent Section 546(e) and related provisions in major bankruptcy cases.

#### Background

In the *Tribune* case, representatives of the Tribune bankruptcy estate sued Tribune's former shareholders to avoid payments the shareholders received during the Company's 2007 leveraged buyout. The estate representatives pursued intentional fraudulent conveyance claims, but did not assert claims for constructive fraudulent conveyance because Bankruptcy Code Section 546(e) barred the "trustee" from bringing such claims. Instead, individual creditors of Tribune subsequently filed state law constructive fraudulent conveyance ("SLCFC") claims in hundreds of lawsuits in more than twenty courts; the cases were consolidated in the U.S. District Court for the Southern District of New York before Judge Richard J. Sullivan. In September 2013, Judge Sullivan dismissed the individual creditors' actions on the basis that individual creditors lacked standing to avoid the shareholder payments while the estate representatives attacked the same transfers as intentional fraudulent conveyances; however, Judge Sullivan rejected the defendants' arguments that the individual creditors' actions were preempted by Section 546(e), holding that the statute bars only a "trustee" from bringing such claims but not individual creditors.

The *Whyte* case presented similar legal issues and was decided by Judge Jed S. Rakoff in the Southern District of New York around the same time as *Tribune*. In *Whyte*, Bankruptcy Code Section 546(g) barred the trustee of debtor SemGroup from asserting SLCFC claims to avoid a novation. In response, the trustee invoked a right to bring SLCFC claims not in her role as the trustee, but rather in her role as the holder and assignee of the rights of SemGroup's creditors. In June 2013, Judge Rakoff dismissed the action on the basis that Section 546(g) preempted the SLCFC claims.

#### Second Circuit Decision

In a unanimous opinion in *Tribune*, the Second Circuit affirmed the dismissal of the individual creditors' actions. While the Circuit disagreed with the District Court's conclusion that the individual creditors lacked standing, it affirmed the dismissal of the action because it likewise disagreed with the District Court's related holding that Section 546(e) did not bar the claims, concluding instead that the claims are in fact barred by the statute. (In a summary order in *Whyte*, the Second Circuit affirmed the dismissal "for substantially the reasons stated in" *Tribune*.)

Noting that the text of the statute is ambiguous as to whether claims brought by someone other than a trustee or other estate representative are precluded, the Circuit looked to the structure of the Bankruptcy Code and legislative history to determine that the congressional purpose of the statute was fatally at odds with the appellants' theory. The Circuit identified the congressional purpose of Section 546(e) to be the promotion of certainty, speed, finality, and stability in the securities markets. Therefore, the Circuit wrote, "the idea of preventing a trustee from unwinding the specified transactions while allowing creditors to do so, but only later, is a policy in a fruitless search of a logical rationale." The Circuit disagreed that the presumption against preemption should be applied in this case, writing that the Bankruptcy Code "constitutes a wholesale preemption of state laws regarding creditors' rights."

The creditors had also argued that after the expiration of the trustee's period of time to commence legal actions (two years), any unused claims reverted to the original holder of the claims—here, the creditors. The Circuit rejected this theory as having "no basis in the Code's language" and criticized the creditors as "adhering to statutory language only when opportune and resolving various ambiguities in a way convenient to that theory." The Circuit took special care to elaborate on the substantial perils to the markets that it foresaw if the creditors prevailed, including a greater degree of uncertainty in consummating securities transactions and the exposure of all investors to litigation risks and costs. At the same time, the Court limited its holding to situations where the estate is barred from bringing such claims; the opinion "resolve[s] no issues regarding the rights of creditors to bring state law, fraudulent conveyance claims not limited in the hands of a trustee et al. by Code Section 546(e) or by similar provisions such as Section 546(g)."

The creditors may petition the full Second Circuit for an *en banc* rehearing or the Supreme Court for *certiorari*. If left to stand, the decision may lead to the end of recent creditor attempts to circumvent Section 546 in this manner, in addition to having broader implications on the scope of preemption stemming from the Bankruptcy Code.

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