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Bankruptcy Code Safe Harbors: Different Treatment for Equitable Claims Based on State Law Versus Foreign Law, and Other Recent Developments

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Bankruptcy Code Safe Harbors: Different Treatment for Equitable Claims Based on State Law or Foreign Law, and Other Recent Developments

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Agenda

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Avoidance Powers of Debtors, Trustees and Creditors

The Code Allows a Bankruptcy Trustee or Debtor In Possession To Claw Back for the Benefit of the Estate Certain Payments or Transfers

Primary Types of Avoidance Actions:

Preferential Transfer	Constructive fraudulent conveyance/transfer	Avoidance under state strong arm provision	Actual fraudulent conveyance/transfer
§ 547	**§§ 548(a)(l)(B) _J L**	**§ 544**	**IL § 548(a)(l)(A)**
• A "**preferential transfer**" is a transfer in respect of an existing debt that is made on the eve of bankruptcy that puts the creditor in a better position than it otherwise would have been.	• A "**constructive fraudulent transfer**" is a transfer made or obligation incurred for less than reasonably equivalent value while the debtor was in a precarious financial condition or which left the debtor in such a position.	• § 544 of the Code allows the trustee to avoid transfers avoidable under applicable state law. • Most states, if not all, have actual and constructive fraudulent transfer/conveyance provisions.	• **"Actual fraudulent transfers**" are made with actual intent to hinder, delay or defraud creditors.

Upon the filing of a Chapter 11 case, all state law creditors' rights, including the right to assert state law fraudulent transfer claims, are vested in the debtor or trustee by operation of Section 544(b).

Avoidance Powers of Foreign Representatives in Chapter 15 Cases

The Avoidance Powers of a "Foreign Representative" in a Chapter 15 Case

Chapter 15 allows a debtor whose main insolvency proceeding is outside of the United States to seek relief from a United States court

Chapter 15 allows a non-US debtor's "foreign representative":

- To obtain a **stay (§ 1520(a)(1)**)
- Access to U.S.-style discovery **(§ 1521(a)(4)**)
- Access to U.S. courts to sue or be sued **(§ 1509(b)(1)**; **§ 1523; § 1524)**
- Ability to administer or realize the debtor's assets within the territorial jurisdiction of the United States **(§ 1521(a)(5))**
- Access to "any appropriate relief" granted by the Court, e.g., recognition/ enforcement of a scheme or plan approved by a non-U.S. court **(§ 1521(a))**

BUT

- A foreign representative cannot obtain relief that would be available to a US debtor or trustee under Sections 544, 547 or 548 of the Bankruptcy Code (i.e., the avoidance powers under the U.S. Bankruptcy Code) **(§§ 1521(a)(4) & (7))**

SO

- If a foreign representative seeks to avoid transfers through a lawsuit in US court, it typically must do so by asserting non-US law claims.

The Bankruptcy Code's Safe Harbors on Avoidance Powers

The Bankruptcy Code's Safe Harbors on Avoidance Powers

- The Bankruptcy Code has statutory safe harbors that protect transfers in connection with particular kinds of transactions or agreements from many of the Code's avoidance provisions if such transfers are made by, to or for the benefit of qualified parties.
- **11 U.S.C. § 546(e)** of the Bankruptcy Code provides a defense to constructive fraudulent transfers and preference claims arising out of securities transactions.
  - "Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b)" of the Bankruptcy Code, "the trustee may not avoid 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" that
    a. "is a margin payment . . . or settlement payment," or
    b. is made "in connection with a securities contract, . . . commodity contract, . . . or forward contract, that is made before the commencement of the case" *
  - Sections 546(f), (g) and (j) provide similar protections with respect to transfers made in connection with repurchase agreements, swap agreements and master netting agreements.
- **11 U.S.C. § 561(d)** of the Bankruptcy Code requires that the safe harbors, including Section 546(e), apply to foreign representatives in cases pending under Chapter 15 of the of the Bankruptcy Code. Section 561(d) states that the safe harbors:
  - "[S]hall apply in a case under chapter 15 . . . To limit avoidance powers to the same extent as in a proceeding chapter 7 or 11 of [the Bankruptcy Code]."
  - **NOTE**: Safe harbors do not limit the ability of a trustee or debtor to assert claims for intentionally fraudulent transfers pursuant to Section 548 of the Bankruptcy Code.

*The definitions of all protected payments and agreements is in **Appendix A**

The Bankruptcy Code's Safe Harbors on Avoidance Powers (*cont'd*)

Safe Harbor Protection Chart

Transactional Category	Contract/Agreement Category	Protected Transaction		Protected Entity	Contract or Agreement
Margin Payments § 546(e)		"Transfer" that is	A "margin" payment	"made by or to (or for the benefit of)" • a commodity broker; • a forward contract merchant; • a stockbroker; • a financial institution; • a financial participant or • a securities clearing agency	
Settlement Payments § 546(e)		"Transfer" that is	A "settlement" payment		"in connection with" • a securities contract; • a commodity contract, or • a forward contract
	Securities, Commodity, and Forward Contracts § 546€ (added in 2006)	"Transfer" that is	A "transfer"		
	Repurchase Agreements §546(f)	"Transfer" that is		"made by or to (or for the benefit of)" • A repo participant or • A financial participant	"in connection with" • a repurchase agreement
	Swap Agreements §546(g)	"Transfer" that is		"made by or to (or for the benefit of)" • a swap participant • a financial participant	"under or in connection with" • a swap agreement

The Purposes of the Bankruptcy Code's Safe Harbors

546(e):

To ensure that speed, liquidity and finality necessary to stable financial markets are not unduly impacted by the bankruptcy of one financial institution.

- "Section 546(e) was intended to protect from avoidance proceedings payments by and to commodities and securities firms in the settlement of securities transactions or the execution of securities contracts. The method of settlement through such entities is essential to securities markets. Payments by and to such entities provide certainty as to each transaction's consummation, speed to allow parties to adjust the transaction to market conditions, finality with regard to investors' stakes in firms, and thus stability to financial markets. Unwinding settled securities transactions . . . would seriously undermine – a substantial understatement – markets in which certainty, speed, finality, and stability are necessary to attract capital." *In re Tribune Co. Fraudulent Conveyance Litig.*, 946 f.3d 66, 91 (2d Cir. 2019).

To protect investors from after-the-fact unwinding of securities transactions.

- "[C]entral to a highly efficient securities market are methods of trading securities through intermediaries. Section 546(e)'s protection of the transactions consummated through these intermediaries was not intended as protection of politically favored special interests. Rather, it was sought by the SEC – and corresponding provisions by the CFTC . . . – in order to protect investors from the disruptive effect of after-the-fact unwinding of securities transactions." *Id.*

561(d):

To protect the financial and securities markets, along with their investors, even when a debtor's primary insolvency proceeding is outside the U.S.

- "Section 561(d)'s adoption along with the expansion of the safe harbor protections reflect Congressional intent to provide broad protection to avoid the spread of financial contagion. While Congress . . . [was] primarily concerned with U.S. creditors and U.S. markets . . .[it] recognized that the financial contagion [it] feared did not stop at the border, and neither the statute nor legislative history suggests that the safe harbors are limited to U.S. creditors or U.S. markets." *In re Fairfield Sentry Ltd.*, 596 B.R. 275, 314 (Bankr. S.D.N.Y. 2018).

Tribune I – The Conduit Safe Harbor and Implied Preemption

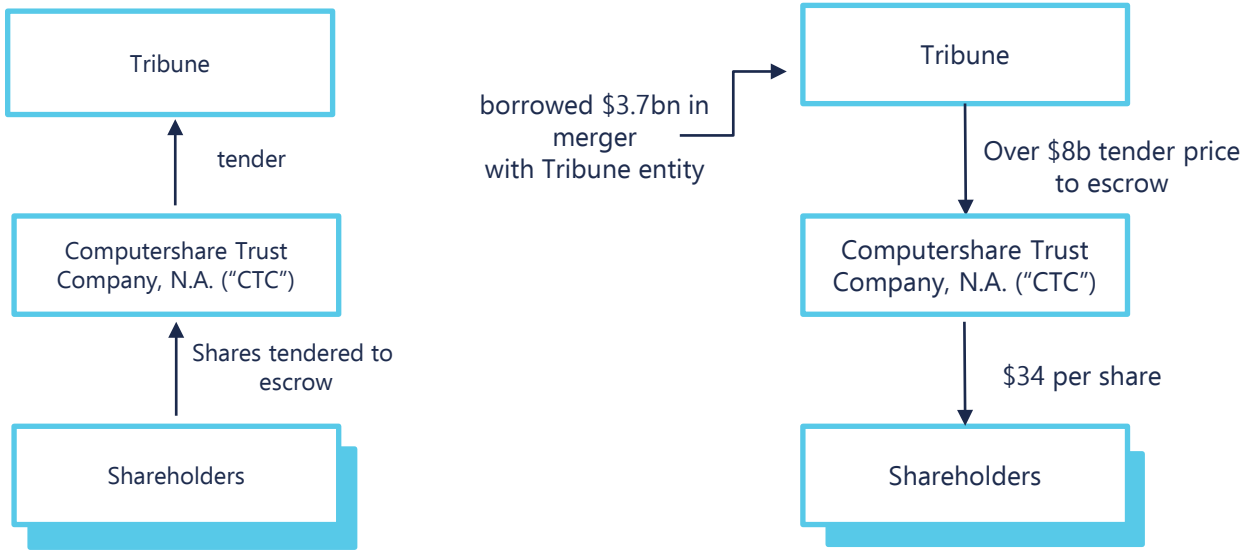
Tribune I – The Conduit Safe Harbor and Implied Preemption

Questions Presented by Tribune

- Whether Section 546(e) impliedly preempts state law constructive fraudulent transfer claims brought by creditors.
- Whether a transfer in a debtor's LBO* would qualify for Safe Harbor protection for the sole reason that a transfer passed through a financial institution

Background

- Tribune was a large media company that was sold to a private investor in 2007 through an LBO. In consummating the LBO:
  - Tribune borrowed $11bn, secured by its assets. This $11bn was used to refinance Tribune's bank debt and cash out Tribune's public shareholders for over $8bn, representing a premium over Tribune's trading price.
  - There were two separate parts to the transaction.



*A diagram and case study explaining the typical mechanics of a LBO is included in Appendix B

Tribune I – The Conduit Safe Harbor and Implied Preemption (cont.)

Background and District Court Opinion

- A year after Tribune's LBO, it commenced a Chapter 11 case in the United States Bankruptcy Court for the District of Delaware.
- When the Bankruptcy Court confirmed Tribune's plan of reorganization, it created a litigation trust, and authorized the litigation trustee to "stand in the shoes of Tribune's trustee," and assert claims on behalf of Tribune's creditors.
- The litigation trustee did not assert state law constructive fraudulent transfer claims within limitations period applicable to trustee-filed claims.
- Thereafter, the Bankruptcy Court authorized individual creditors to assert state law constructive fraudulent conveyance claims outside of bankruptcy court.
- Hundreds individual creditors filed suits, which were consolidated in the United States District Court for the Southern District of New York.
- Although the District Court ultimately dismissed the creditors' state law constructive fraudulent transfer claims, it rejected the defendant shareholders' argument that the creditors' claims were preempted by Section 546(e),
  - The District Court held that Section 546(e) "applied only to a bankruptcy trustee . . . and [that] . . . Congress had declined to extend Section 546(e) to state law, fraudulent conveyance claims brought by creditors."

Tribune I – The Conduit Safe Harbor and Implied Preemption (*cont'd*)

The Second Circuit Held that State Law Claims Are Preempted Because They Conflict With Section 546(e)

***First*, the transfers at issue fell within the scopes of Section 546(e)**

- The LBO transfers were "settlement payments" or made "in connection with a securities contract," even if the financial institutions that received or made such transfers acted only as conduits for the for money paid from a buyer to selling shareholders.
- Section 546(e)'s language clearly covers payments, such as those at issue here, "by commercial firms to financial intermediaries to purchase shares from the firm's shareholders."

***Second*, Section 546(e) impliedly pre-empts state law avoidance claims brought by creditors when the payment or transfer at issue falls within the scope of the statute, even if the claim is not brought by a "trustee"**

- Even though Section 546(e) expressly refers only to "avoidance by a trustee," and not "creditors acting on [its] behalf," Congress still intended to preempt state law fraudulent transfer claims asserted by creditors that would be safe harbored by Section 546(e) if brought by a trustee or debtor.
- Allowing creditors to assert their state law fraudulent conveyance claims would conflict with the Bankruptcy Code's statutory scheme.
  - Upon the filing of a Chapter 11 case, all state law creditors' rights, including the right to assert state-law fraudulent transfer claims, are vested in the debtor or trustee by operation of Section 544(b).
  - If the transfer falls within the scope of Section 546(e), then a trustee would be able to assert only a claim to recover an actually fraudulent transfer.
  - Even if the right to assert a state law fraudulent transfer claims reverts to creditors if it is not timely asserted by the trustee (a proposition for which there is no support in the Bankruptcy Code), "[t]here is little apparent reason to limit trustees to intentional fraud claims while not extinguishing constructive fraud claims but rather leaving them to be brought later by individual creditors."

Tribune I – The Conduit Safe Harbor and Implied Preemption (*cont'd*)

Permitting creditors to bring state law constructive fraud transfers would be "in irreconcilable conflict" with "[e]very congressional purpose reflected in Section 546(e)."

- Regardless of whether the clawback claims were brought by a trustee under the Bankruptcy Code or by creditors under state law, "unwinding settled securities transactions," years after the fact, would undermine the stability of the securities markets "in which certainty, speed, finality, and stability are necessary."
- "Allowing creditors to bring claims barred by Section 546(e) to the trustee only after the trustee fails to exercise powers it does not have would increase the disruptive effect of an unwinding by lengthening the period of uncertainty for intermediaries and investors. Indeed, 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."
- The Second Circuit "resolved no issues regarding the rights of creditors to bring state law fraudulent conveyance claims not limited" by Section 546(e) "in the hands of a trustee."

Tribune II: Continued Preemption of State Law Constructive Fraudulent Transfer Claims

Tribune II: Continued Preemption of State Law Constructive Fraudulent Transfer Claims

Background

- After *Tribune I*, the individual creditors filed a petition for certiorari to the Supreme Court. The Supreme Court, however, did not grant or deny certiorari in Tribune.
- This is because, in a case called *Merit Management*, which was decided after *Tribune I,* the Supreme Court overruled Second Circuit decisions holding that Section 546(e) protected transfers where a financial institution merely acted as an intermediary
- Following the Supreme Court's ruling in *Merit*, Justices Kennedy and Thomas issued a statement urging the Second Circuit to "recall its mandate," in *Tribune* and consider whether to entertain a . . . motion to vacate the earlier judgment . . . in light of this Court's decision" in *Merit*.
- While *Merit* overruled one basis for the Second Circuit's decision in *Tribune*, it left unresolved the issue of whether Section 546(e) preempts state law fraudulent transfer claims asserted by creditors unresolved.
- The Second Circuit recalled its mandate and, in considering the creditors' motion to vacate, heard further arguments further about implied preemption and whether 546(e) safe harbored the transfer in light of the "customer" safe harbor.

Tribune II: Continued Preemption of State Law Constructive Fraudulent Transfer Claims (*cont'd*)

The Second Circuit's revised decision

- In a revised opinion issued on December 19, 2019, the Second Circuit reaffirmed its previous decision that the creditors' state law constructive fraudulent transfer claims were preempted by the section 546(e) safe harbor.
- *First*, the transfers were *still* covered by Section 546(e), notwithstanding *Merit's* holding that 546(e) does not apply if a financial institution is mere conduit
  - The definition of "financial institution" in the Bankruptcy Code was broad enough to cover Tribune, in connection with the LBO because a bank was acting as an agent for Tribune in connection with the transfers. Thus, the transfers constituted a transfer from a financial institution made in connection with a securities contract and settlement payment, fell within the scope of the safe harbor, and claims to avoid the transfer would be expressly barred if brought by a "trustee" or debtor.
- *Second*, the Supreme Court's decision in *Merit* did not abrogate the Second Circuit's holding in *Tribune I* that Section 546(e) preempted creditors' state law fraudulent transfer claims that would be state law fraudulent transfer claims that would be safe-harbored if asserted by a debtor or trustee.
  - *Merit* did not address preemption, but the viability of the "mere conduit" theory. It did not implicate "in any way" any of the Second Circuit's "reasons underpinning [its] preemption holding."

Tribune II: Continued Preemption of State Law Constructive Fraudulent Transfer Claims

The Supreme Court Denies *Certiorari*

- In July 2020, the creditors in *Tribune* filed their second petition for certiorari. In October, 2020, the Supreme Court invited the Solicitor General to file a brief on behalf of the government.
- The Solicitor General contended that the Second Circuit erred in finding that creditors' state-law avoidance actions were preempted by Section 546(e), and that the court's interpretation of "financial institution" is also questionable.
- However, the Solicitor General said that Supreme Court review is unwarranted currently because neither question is the subject of a circuit split, and the Court would benefit from additional analysis from other courts of appeal.
- In other words, the Solicitor General is inviting other federal courts of appeal to disagree with the Second Circuit.
- The Supreme Court denied the creditors petition for certiorari on April 19, 2021.

Fairfield Sentry – Application of the Safe Harbor to Foreign Law Claims in Chapter 15

Fairfield Sentry: Application of the Safe Harbor to Foreign Law Claims in Chapter 15

Question Presented

Does the Section 546(e) Safe Harbor, as applied to Chapter 15 cases by Section 561(d), bar a "foreign representative" from asserting a foreign common law claim that would effectively unwind a transfer within the scope of the Safe Harbor?

Background

- Fairfield Sentry, along with sister funds, were British Virgin Islands ("**BVI**")-registered investment funds that offered non-U.S. investors exposure to Bernard Madoff's investment strategy. While the funds were operational, investors could subscribe to shares in the funds and redeem their shares.
- After Madoff's fraud was exposed, the Fairfield funds stopped making redemption payments and commenced liquidation proceedings in the BVI. The liquidators (the "**Liquidators**") in the BVI proceedings also commenced a Chapter 15 case as "foreign representatives" in the United States Bankruptcy Court for the Southern District of New York.
- The Liquidators asserted several claims under BVI law in over 300 adversary proceedings in the Fairfield funds' Chapter 15 case, seeking to claw back the redemption payments made before Madoff was arrested. Typically, the defendants were banks that purchased shares in the funds and the unknown bank customers on whose behalf the shares were purchased.
- The Liquidators asserted claims under the BVI Insolvency Act and constructive trust claims asserted under BVI common law. The defendants argued that the Section 546(e), applicable in a Chapter 15 case through Section 561(d), barred both sets of claims.

Fairfield Sentry: Application of the Safe Harbor to Foreign Law Claims in Chapter 15 (*cont'd*)

The Bankruptcy Court's Decision

- The court ruled that Section 561(d) applied to claims asserted under foreign law but reached different conclusions on whether Section 546(e) bars the BVI Insolvency Act Claims and whether Section 546(e) bars the BVI constructive trust claims.
- *The BVI Insolvency Act claims*. The claims were "avoidance" actions because the elements of the claims "resemble" preference and constructive fraudulent transfer claims under U.S. law. Thus, the Section 546(e) and 561(d) barred these claims if the transfers the Liquidators sought to avoid fell within the scope of Section 546(e). They did because the redemption payments were "settlement payments" made "in connection with a securities contract" by a financial institution (the court ruled that both the funds and their administrators were financial institutions). The court therefore dismissed these claims.

Fairfield Sentry: Application of the Safe Harbor to Foreign Law Claims in Chapter 15 (*cont'd*)

The Bankruptcy Court's Decision (*cont'd*)

- *The BVI constructive trust claims.* The court acknowledged that several other courts have relied on the Supremacy Clause in the U.S. Constitution to rule that Section 546(e) impliedly preempts U.S. state law claims that would have the effect of avoiding transactions covered by the Safe Harbor, even though 546(e) expressly bars only avoidance claims asserted by a "trustee." In the case of state law claims, the court recognized that "[a]llowing a plaintiff to recover a safe harbored transfer by attaching a different label to the claim would frustrate the purpose of section 546(e)."
- Nevertheless, the court held that Section 546(e) did not bar the BVI constructive trust claims. The court held that the Supremacy Clause does not preempt foreign law, even when applying foreign law would be contrary to the purposes of U.S. federal law. Thus, "otherwise applicable foreign law" could not be preempted by Section 546(e) "absent express statutory language to that effect."
- Because there was no "express statutory language" in Section 546(e) or Section 561(d) preempting the BVI constructive trust claims, the court denied defendants' motion to dismiss the claims as safe harbored transactions.
- The court rejected the argument that allowing a BVI constructive trust claim to unwind an otherwise safe harbored transactions would frustrate the purpose of Section 546(e). Courts considering whether state law claims are impliedly preempted have generally examined "the remedy sought rather than the allegations pled," and, if the state law claims seek the same remedy as an avoidance action, the claims are preempted by Section 546(e). Contrary to this precedent, the court held that the BVI constructive trust claims were not preempted because they required "different theories and different proof."

Looking Ahead

Potential Effects of the *Fairfield Sentry* Decision

- The defendants have moved for interlocutory appeal of the denial of the motion to dismiss. That appeal is pending.
- Issues on Appeal:
  - Whether the decision is contrary to Second Circuit precedent holding that the Safe Harbors preempt state law claims that would have the effect of unwinding transfers that are safe harbored from clawback claims asserted by a trustee.
  - Whether allowing a "foreign representative" to unwind such transfers by asserting common law claims is contrary to public policy such that the Bankruptcy Court should decline to allow the Liquidators to pursue their claims?
    - 11 USC § 1506 permits a court to refuse to take an action under the Bankruptcy Code "if the action would be manifestly contrary to the public policy of the United States." Although the statute is read narrowly, "it should be invoked when fundamental policies of the United States are at risk."
      - If the Second Circuit finds that allowing foreign representatives to unwind otherwise safe harbored transfers may interfere with the fundamental policies of ensuring stability, liquidity and finality of transactions in financial and securities markets, it could decide that the Liquidators' cannot bring their BVI common law claims in a Chapter 15 case.
    - Per 11 USC § 1522, US bankruptcy courts may not grant discretionary relief in Chapter 15 cases, including allowing foreign representatives to seek to recover assets through US courts, unless the interests of creditors and other interested entities are "sufficiently protected."
      - If the Second Circuit concludes that investors in the securities or financial markets would not be sufficiently protected given their exposure to clawback of long-settled transactions, it could also decline to allow the Liquidators to assert BVI common law claims.

Potential Effects of the *Fairfield Sentry* Decision (*cont'd*)

- If the district court refuses to hear the interlocutory appeal or affirms the bankruptcy court's decision, this decision could impact financial and securities markets going forward.
  - *First*, other "foreign representatives" may seek to unwind long-settled transactions using foreign common law claims. So long as foreign debtors can identify differences in theories and proof between their asserted foreign law claim and an avoidance claim, they may be able to achieve the same remedy as if they brought an avoidance claim. And as these claims may have longer statutes of limitation than avoidance claims, this decision may expand the scope of transactions available to unwind.
    - The decision potentially blows open the doors for any non-US entity that is a counterparty on a transaction that would otherwise be protected by the Safe Harbors to file a Chapter 11 case in the US or file a non-US proceeding coupled with a Chapter 15 ancillary proceeding in the US, and then dress up avoidance type claims (that would be barred by the Safe Harbors) as equitable claims (such as constructive trust, unjust enrichment, etc.) to circumvent the Safe Harbors and pursue those claims in US courts.
    - Because there is virtually no jurisdictional bar to the commencement of a case under Chapter 11 or Chapter 15 of the US Bankruptcy Code, the this phenomenon could be significant. Any entity with property in the United States (however de minimis) is entitled to commence a case under Chapter 11 or Chapter 15 of the US Bankruptcy Code even if (a) it is not organized in the US, (b) the relevant agreement is governed by non-US law and/or (c) the financial institution or financial participant is not a US entity.

Potential Effects of the *Fairfield Sentry* Decision (*cont'd*)

- *Second*, the decision may dampen participation in the financial and securities markets. As the Second Circuit explained in Tribune II, exposure to even weak lawsuits could cause financial institutions to set aside greater reserves in anticipation of potential litigation. This of course will make it more expensive to raise capital.
- *Third*, a challenge to the effectiveness of the safe harbors could be a substantial issue for financial institutions and financial participants.
  - The continued availability of bankruptcy and insolvency Safe Harbors that give special status to "settlement payments" and terminations and close-outs under trading agreements (such as ISDA derivatives contracts, repos, securities lending and prime brokerage agreements) are key to the smooth functioning of our financial markets.
  - If a counterparty becomes the subject of a bankruptcy or insolvency proceeding in the US, the Safe Harbors are designed to protect settlement payments and allow financial institutions and financial participants (such as banks/ broker-dealers) to terminate these agreements, exercise any netting rights, and apply any collateral available to satisfy net termination amounts owing without having to seek relief from the automatic stay in the bankruptcy court.
- *Finally*, the decision could prejudice U.S. banks' ability to act as intermediaries in transactions involving foreign investors. Here, either the U.S. banks that received the transfers will have to return redemption payments that they received for the benefit of, and likely passed on to, their clients, or their clients may face claims for avoiding and recovering subsequent transfers because they chose a U.S. financial institution or a U.S. branch of a foreign financial institution to act as an intermediary in their investment in the Fairfield funds. The added cost and risk that using a US-based intermediary to raise capital may add could disadvantage the US as a financial market relative to other financial markets.

Courts in the Second Circuit Extend Implied Preemption to (1) State Law Common Law Claims and (2) State Law Claims for Actually Fraudulent Conveyances

***In re Nine W. LBO Sec. Litig.*, 2020 WL 5049621 (S.D.N.Y. Aug. 27, 2020)**

- A litigation trustee asserted US state-law actual and constructive fraudulent transfer claims pursuant to 11 U.S.C. § 544 on behalf of Nine West's creditors, seeking to avoid and recover transfers to shareholders that were made in connection with the pre-bankruptcy leveraged buyout of Nine West. The litigation trustee also brought unjust enrichment claims against certain former directors and officers seeking disgorgement of the payments these persons received in return for the cancellation of their shares in the Nine West LBO.
- The indenture trustee for various notes issued by Nine West also brought constructive and intentional fraudulent conveyance claims challenging the same payments but pursuant only to state law.
- Because the transfers were subject the Section 546(e) safe harbor, the litigation trustee's Section 544 claims were barred per the plain text of Section 546(e).
- Moreover, the indenture trustee's state law claims (including actual and constructive fraudulent transfer claims) were preempted by Section 546(e)
  - Arguably, this was an extension of *Tribune*, since the Second Circuit there held only that constructive fraudulent transfer claims asserted by creditors were preempted.
- The litigation trustee's unjust enrichment claims were also preempted by Section 546(e).
  - The district court rejected the trustees' argument that, because the unjust enrichment claims were not identical to the avoidance claims, they were not preempted.
    - "[I]t is the remedy sought, rather than the allegations pled, that determines whether § 546(e) preempts a state law claim." Because the unjust enrichment claims "s[ought] to recover the same payments held unavoidable under § 546(e), it would render§ 546(e) meaningless, and would wholly frustrate the purpose behind that section" to allow the unjust enrichment claim to proceed.

Courts Extend Implied Preemption to (1) State Law Common Law Claims and (2) Actually Fraudulent Conveyance Claims (*cont'd*)

In re Boston Generating LLC, **617 B.R. 442 (Bankr. S.D.N.Y. 2020**

- The Liquidating Trustee of Boston Generating LLC brought state-law claims for unjust enrichment, and constructive and intentional fraudulent conveyance claims pursuant to state law only. The Trustee sought to recover payments and dividends sent to the company's interest holders in connection with a tender offer that Boston Generating launched as part of a leveraged recapitalization transaction.
- The transfers fell within the scope of Section 546(e), and therefore trustee's constructive fraudulent transfer claims were preempted by Section 546(e) for the same reasons as the trustee's similar claims were preempted in *Tribune*.
- Like the *Nine West* court, the court also held that the state law claims for actually fraudulent transfers were preempted by Section 546(e)
  - The Court was "bound by the plain language of section 546(e), which provides an exception only for intentional fraudulent transfer claims brought under [Section 548(a) of] the Bankruptcy Code and no more."
  - "Congress may have specifically excluded state law intentional fraudulent transfer claims from section 546(e)'s exception having determined the need for stability in the securities markets overrode the potential danger of creditors escaping claims for intentional fraud based on a fear that inconsistent application of fifty (50) states' fraudulent transfer statutes would result in instability in the securities markets."
- Section 546(e) also pre-empted the Trustee's claims for unjust enrichment:
  - "The unjust enrichment claim seeks to recover the same payments held unavoidable under § 546(e)." Thus, "allowing recovery for unjust enrichment would implicate the same concerns regarding the unraveling of settled securities transactions which is precisely the result that section 546(e) precludes. The Court could not permit the unjust enrichment claim to go forward without frustrating the purpose of Section 546(e)."

Lower Courts Outside the Second Circuit Have Reached a Different Result

***In re Physiotherapy Holdings Inc.*, 2016 Bankr. LEXIS 2810 (Bankr. Del. June 20, 2016)**

The Physiotherapy adversary proceeding arose out of a reverse merger transaction that resulted in, among other things, the payment of approximately $248.6 million to certain selling shareholders of Physiotherapy Holdings, Inc. In April 2013, Physiotherapy defaulted on the senior notes issued in connection with the merger transaction, and in November 2013, Physiotherapy initiated its bankruptcy case.

A Litigation Trust, to which Physiotherapy's creditors assigned their claims, asserted, *inter alia,* constructive and fraudulent transfer claims pursuant to state law and the Bankruptcy Code.

Because the transfers fell within the scope of Section 546(e), the Trust's federal law constructive transfer claims were barred by the safe harbor.

However, Section 546(e) did not preempt the Trust's state law constructive fraudulent transfer claims:

- The Delaware bankruptcy court disagreed with the Second Circuit in *Tribune* that one purpose of Section 546(e) was to promote finality for individual investors. Rather the purpose is to mitigate systemic risk. Allowing the state law constructive claims which sought to recover payments for privately traded securities, would have no further ripple effect on the financial and securities markets, and therefore would not serve as an obstacle to the policies in Section 546(e).
- Section 546(e) applies only to a bankruptcy trustee, not individual creditors. The language contained in Section 544(b)(2), which expressly bars an individual creditor's ability to bring a state law fraudulent transfer claim to avoid certain charitable contributions, does not appear in Section 546(e). This suggested that Congress did not intend Section 546(e) to create any such bar to creditors state law constructive fraudulent transfer claims in other contexts.
- Congress did not intend Section 546(e) to protect corporate insiders who allegedly acted in bad faith.

Thus, "a litigation trustee may assert state law fraudulent transfer claims in the capacity of a creditor-assignee when: (1) the transaction sought to be avoided poses no threat of 'ripple effects' in the relevant securities markets; (2) the transferees received payment for non-public securities, and (3) the transferees were corporate insiders that allegedly acted in bad faith."

Final Thoughts

In the Second Circuit, if a transfer falls within the Scope of Section 546(e), US debtors and trustees in Chapter 11 cases will struggle to assert any US claims to unwind transfer aside from intentionally fraudulent conveyance claims pursuant to Section 548(a) of the Bankruptcy Code.

- The comparatively short look back period in which transfers may be recovered (2 years prior to the commencement of a bankruptcy case), will limit the transfers subject to Section 548(a) of the Bankruptcy Code.

Debtors, trustees and creditors will find it difficult to assert state law claims–including common law and statutory avoidance claims–where a transfer otherwise falls within the scope of the safe harbor.

However, absent reversal of the *Fairfield Sentry* decision, foreign representatives in Chapter 15 cases will be able to assert non-US common law claims to avoid transfers that fall within the scope of Section 546(e), and thus will be able to assert non-US claims that would be pre-empted if asserted under US law.

- Enterprising and creative foreign representatives can be expected to assert otherwise applicable non-US law avoidance or US law common law claims in the form of non-US common law claims.
- There likely will be disputes over whether non-US or US law applies, given that this may be determinative of the pre-emption issue.

There is not yet any circuit split concerning the scope of implied pre-emption under Section 546(e). But, given the Section Circuit's *Tribune* decisions, and that other lower courts outside the Second Circuit have declined to follow *Tribune*, debtors and creditors seeking to recover transfers that are arguably within the scope of Section 546(e) will seek to file their claims outside of the Second Circuit (as happened with hundreds of creditors' claims in *Nine West*).

- Where possible, the defendants will try to transfer and consolidate these claims to multidistrict litigation proceeding within the purview of the Second Circuit (as also happened in Nine West).

Appendices

APPENDIX A: The Bankruptcy Code's Safe Harbors on Avoidance Powers: Protected Payments and Agreements

Protected Agreements:

Securities Contracts (11 U.S.C. § 741 (7))

- Purchases, sales or loans of:
  - Equity, debt or other security
    - Cash transactions
    - Underwriting and share subscriptions
  - Certificate of deposit
  - Mortgage loan or interest in a mortgage loan
- Options on the above
- Repos and reverse repos on the above
- Listed FX options
- Margin loans and settlement credit
- Loan-plus-collar

Commodities Contracts (11 U.S.C. § 761 (4))

- Futures, cleared swaps and related transactions

Repurchase Agreements (11 U.S.C. § 101(47))

- Repos and reverse repos:
  - Treasuries and agencies
  - Qualifying non-U.S. treasuries
  - Mortgages and interests in mortgages
  - Mortgage-related securities
  - Certificates of deposit and bankers acceptances

Forward Contracts (11 U.S.C. § 101 (25))

- Purchase, sale or transfer of:
  - A commodity (other than under "commodity contract" definition)
  - Other articles, rights subject to forward dealing

Swap Agreements (11 U.S.C. § 101 (53B))

- Swaps, options, futures, forwards, floors, caps, etc.:
  - Rates, FX, precious metals, commodities, equities, debt, indexes, total return, credit default, spreads, basis, weather, emissions, inflation
  - Anything similar to the above

All definitions include

- Related master agreements
- Related guarantees or other credit support

APPENDIX A: The Bankruptcy Code's Safe Harbors on Avoidance Powers: Protected Payments and Agreements *(cont'd)*_

Protected Payments

Settlement Payment	Margin Payment
• "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade." 11 USC 741(8). The term refers to any payment that "complete[s] a transaction in securities." *Enron Creditors' Recover Corp. v. Alfa, S.A.B. de C.V., 651 F.3d 505, 515-16 (2d Cir. 2011*).	• "payment or deposit of cash, a security, or other property, that is commonly known to the securities trade as original margin, initial margin, maintenance margin, or variation margin, or as a mark-to-market payment, or that secures an obligation of a participant in a securities clearing agency." 11 USC 741(5).

APPENDIX B: Mechanics of a Leveraged Buyout

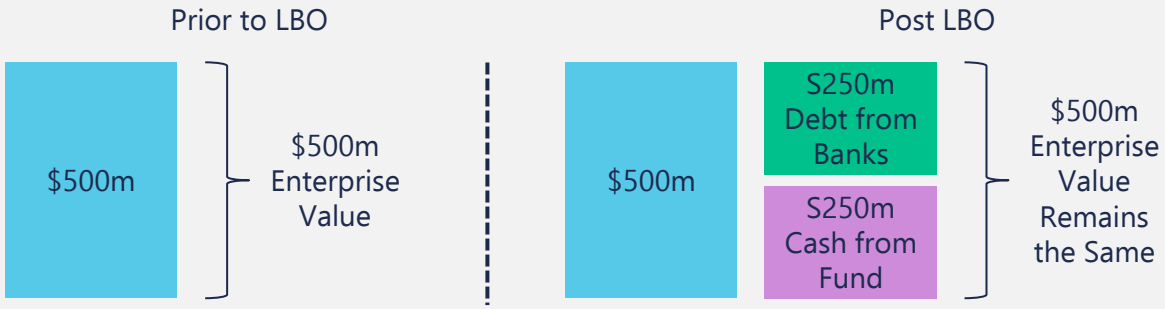
Safe Harbors Most Commonly Arise in the context of a leveraged buyout

Case Study: Leveraged Buyout (LBO)

Most common context in which safe harbors have risen

- An LBO is the acquisition by an investor of a controlling interest in a company's equity, where a significant percentage of the purchase prise is financed through leverage (debt) secured by the company's assets.
- Failed LBOs > Bankruptcy > Fraudulent Conveyance Litigation.
- Trustee likely will try to claw back money that parties received from the LBO.

Simple LBO



Thank you