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Lyondell Bankruptcy Court Holds That Safe Harbors Do Not Prohibit Creditors From Asserting State Law Constructive Fraudulent Transfer Claims

January 29, 2014

On January 14, 2014, Judge Robert E. Gerber of the United States Bankruptcy Court for the Southern District of New York in [*Weisfelner v. Fund 1. \(In re Lyondell Chemical Co.\), Adv. Proc. No. 10-4609 \(REG\), 2014 WL 118036 \(Bankr. S.D.N.Y. Jan. 14, 2014\)*](#) held that section 546(e) of the Bankruptcy Code did not bar or preempt state law fraudulent transfer claims asserted on behalf of creditors to recover certain leveraged buyout transfers made to shareholders. In so holding, the Bankruptcy Court adopted the rationale of Judge Richard J. Sullivan of the United States District Court for Southern District of New York in *In re Tribune Co. Fraudulent Conveyance Litig.*, 499 B.R. 310 (S.D.N.Y. 2013), and rejected the rationale of Judge Jed. S. Rakoff in *Whyte v. Barclays Bank PLC*, 494 B.R. 196 (S.D.N.Y. 2013), thus adding to the recent debate in the Southern District of New York as to what effect the Bankruptcy Code's safe harbor provisions have on state law fraudulent transfer actions.

Background

In December 2007, Basell AF S.C.A. acquired Lyondell Chemical Company through an LBO, whereby Lyondell assumed \$21 billion in secured debt and its shareholders received \$12.5 billion of the loan proceeds. Just over one year later, Lyondell and certain of its affiliates filed for chapter 11 protection. On April 23, 2010, the Bankruptcy Court confirmed Lyondell's plan of reorganization. Pursuant to the plan, the debtors abandoned certain state law fraudulent transfer claims that they could have asserted against Lyondell's former shareholders pursuant to section 544 of the Bankruptcy Code, and the Creditor Trust was created to prosecute those claims on behalf of certain Lyondell creditors.

Following confirmation, the Creditor Trust commenced an action in the New York State Supreme Court asserting directly (and not pursuant to section 544 of the Bankruptcy Code) these state law fraudulent transfer claims. Upon the application of certain defendants, the action was removed to the United States District Court for the Southern District of New York and then automatically referred to the Bankruptcy Court. The defendants then filed a motion to dismiss, arguing that

section 546(e) of the Bankruptcy Code provides a substantive defense to and impliedly preempts the Creditor Trust's fraudulent transfer claims. In addition, the defendants contended that (i) the Creditor Trust may not recover because the funds transferred in the LBO were not the debtors' property; (ii) certain defendants were only non-beneficial owners or conduits; (iii) the Creditor Trust lacked standing to sue on behalf of the LBO lenders because those lenders ratified the LBO transactions; and (iv) the Creditor Trust failed to adequately plead its intentional fraudulent transfer claims.

The Court's Opinion

Before turning to the defendants' preemption argument, the Bankruptcy Court first rejected the Defendants' argument that section 546(e) applied to the Creditor Trust's state law fraudulent transfer claims, holding that "there is no statutory text making section 546(e) applicable to claims brought on behalf of individual creditors, or displacing their state law rights, by plain meaning analysis or otherwise." *Lyondell*, 2014 WL 118036, at *6.

With respect to preemption, the defendants based their argument on the obstacle branch of conflict preemption, which "precludes state law that poses an actual conflict with the overriding federal purpose and objective." *Id.* at *10 (quoting *In re Methyl Tertiary Butyl Ether Prods. Liab. Litig.*, 725 F.3d 65, 101 (2d Cir. 2013)). Relying on the *Tribune* decision, the Bankruptcy Court also rejected this argument and held that state fraudulent transfer law does not conflict with the purposes of the Bankruptcy Code as a whole or section 546(e) itself. Specifically, the Bankruptcy Court found that if Congress intended that section 546(e)'s purpose of protecting securities markets should override the other long-recognized purposes of the Bankruptcy Code advanced through avoidance actions, it could have evidenced that intent by expressly preempting state law fraudulent transfer actions in section 546(e). Congress did not, however, expressly preempt those claims, in stark contrast to where Congress expressly preempted state laws providing for the recovery of certain charitable transfers in section 544(b)(2) of the Bankruptcy Code. *Id.* at *11-16. In addition, drawing a distinction between financial markets and financial participants, the Bankruptcy Court found that state law fraudulent transfer actions against shareholders that received consideration in an LBO do not obstruct 546(e)'s purpose of protecting financial markets. *Id.* at *16-19.

In holding that section 546(e) does not preempt state fraudulent transfer law, the Bankruptcy Court, again in reliance on *Tribune*, rejected the reasoning of *Whyte*, where the district court held that section 546(g) of the Bankruptcy Code preempts state law fraudulent transfer claims that were assigned to a trust along with avoidance claims arising under the Bankruptcy Code. First, the Bankruptcy Court found *Whyte* factually distinguishable. The trustee in *Whyte* was empowered to assert both bankruptcy estate claims and creditor claims, theoretically allowing for the trust to assert avoidance claims (as a creditor representative) that section 546(g) would otherwise bar it

from asserting under section 544 (as an estate representative). In contrast, the Creditor Trust was only a creditor representative that could assert those creditors' claims. *Id.* at *20. Further, the Bankruptcy Court found that the *Whyte* court's preemption analysis was flawed – the district court failed to apply the legal presumption against preemption, failed to consider the Bankruptcy Code's objectives as a whole, accepted a market disruption argument against preemption without thorough analysis, and seemingly allowed its concern over the differing results arising from state and federal avoidance laws to trump settled preemption standards. *Id.* at *21-23.

The Bankruptcy Court next rejected the defendants' argument that the funds transferred in the LBO were not the debtors' property because the Creditor Trust plausibly alleged facts warranting that the multi-step LBO be collapsed into a single transaction. *Id.* at *23-26. The Bankruptcy Court, however, accepted the defendants' remaining arguments and narrowed the Creditor Trust's claims. Specifically, the Bankruptcy Court held that the Creditor Trust's claims against any conduits or non-beneficial owners of stock must be dismissed, and that the Creditor Trust's claims brought on behalf of LBO lenders must be dismissed because those lenders ratified the LBO through their participation. Finally, the Bankruptcy Court held the Creditor Trust failed to adequately plead its claims of intentional fraudulent transfer, but dismissed those claims without prejudice so that the Creditor Trust could replead them with more particularity. *Id.* at *26-33.

Conclusion

Lyondell marks the latest in a string of recent, conflicting decisions from the Southern District of New York concerning whether the Bankruptcy Code's avoidance action safe harbors bar or otherwise preempt creditors or creditor representatives from directly asserting state law fraudulent transfer claims. The Second Circuit will, however, hear the appeals of the *Tribune* and *Whyte* decisions in tandem later this year and presumably dictate how *Lyondell* itself will fare on appeal.

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