



Bankruptcy & Financial Restructuring / Finance ADVISORY ■

APRIL 12, 2016

Second Circuit Rejects Potential Loophole in the Securities Contract Safe Harbor

The Second Circuit Court of Appeals recently held that the “safe harbor” protections for securities contracts in Section 546(e) of the Bankruptcy Code prevented individual creditors’ state law constructive fraudulent transfer claims against the former shareholders of Tribune Media Company for amounts received as part of a leveraged buyout (LBO). The Second Circuit specifically held that the creditors’ state law constructive fraudulent transfer claims were preempted by the securities contract safe harbor in the Bankruptcy Code, closing a potential loophole that individual creditors could use as a workaround to attack transactions that otherwise would be protected by the safe harbor.¹

Background

In 2007, Tribune, a multimedia corporation, was purchased in an LBO. Tribune borrowed over \$11 billion secured by its assets and combined that \$11 billion with \$315 million in equity from its acquirer to refinance Tribune’s existing debt and cash out Tribune’s shareholders. The \$8 billion used to cash out the shareholders was transferred to a financial intermediary and then to the shareholders in exchange for their shares. In 2008, Tribune filed for bankruptcy.

During the administration of the bankruptcy case, multiple theories of fraudulent transfer claims emerged. The creditors’ committee brought “actual intent” fraudulent transfer claims against the former shareholders, seeking to unwind the \$8 billion cash out. Although having an exclusive right to pursue constructive fraudulent transfer claims during a two-year period, the creditors’ committee elected not to pursue such claims because they would have been barred under Section 546(e). After the creditors’ committee allowed the two-year limitations period to lapse on the constructive fraudulent transfer claims, the bankruptcy court granted individual creditors of Tribune relief from the automatic stay to bring their alleged state law constructive fraudulent transfer claims, holding that the creditors’ committee’s failure to assert such claims meant that the individual creditors again had standing to assert such claims.

The individual creditors then sued the shareholders and financial intermediaries in several federal and state courts, which were later consolidated in a multidistrict proceeding in the Southern District of New York. Although the district court granted the shareholders’ motion to dismiss on standing grounds, the district court rejected the shareholders’ argument that Section 546(e) barred the state law constructive fraud claims, holding that only a “trustee” was barred from pursuing such claims.

¹ Section 546(e) of the Bankruptcy Code is a limitation on a trustee’s avoiding powers. Section 546(e) states that notwithstanding Sections 544, 545, 547, 548(a)(1)(B) and 548(b) of the Bankruptcy Code, the trustee may not avoid a transfer that is a “margin payment” or “settlement payment” made by, to “or for the benefit of” a “commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency” before the commencement of a bankruptcy case.

The Second Circuit's Reasoning

The Second Circuit reversed the district court and held that the individual creditors' claims were barred by the safe harbor in Section 546(e).² The Second Circuit applied federal preemption principles—grounded in the Supremacy Clause of the U.S. Constitution—reasoning that “[o]nce a party enters bankruptcy, the Bankruptcy Code constitutes a wholesale preemption of state laws regarding creditors’ rights.... Unwinding settled securities transactions by claims such as appellants’ would seriously undermine—a substantial understatement—markets in which certainty, speed, finality, and stability are necessary to attract capital.”

In validating the safe harbor's application to state law constructive fraudulent transfer claims brought by individual creditors, the Second Circuit noted that “the policies reflected in Section 546(e) relate to securities markets, which are subject to extensive federal regulation,” which “has existed and grown for over eighty years and reflects very important federal concerns.” In short, the Second Circuit ruled that if it allowed the individual shareholders to unwind the transfers using state law constructive fraudulent transfer claims, it “would have to construe Section 546(e) as achieving the opposite of what it is intended to achieve.”

Implications & Takeaways

Tribune is another in a recent string of cases in which the Second Circuit has broadly interpreted the securities contract safe harbor.³ With this decision, definitive circuit-level authority now exists to close a perceived loophole in the safe harbor protections—one where the bankruptcy trustee or other estate representative exercising the powers of a trustee, such as the creditors' committee, chose not to bring constructive fraudulent transfer claims under Section 544, allowing such claims to again vest with individual creditors. These individual creditors then argued that the plain language of Section 546(e) only applied to a “trustee” and not individual creditors seeking to avoid the same transactions under state law. Although the bankruptcy court in *Lyondell* credited the plain language argument, the Second Circuit reasoned that the plain language argument created ambiguities, anomalies and conflicts with the purposes of the safe harbor, which are to protect from avoidance proceedings payments by and to financial intermediaries in the settlement of securities transactions or the execution of securities contracts. The Second Circuit held that “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.”

With the Second Circuit's holding that Section 546(e) preempts individual creditors' state law constructive fraudulent transfer claims, LBO participants who qualify under the Section 546(e) safe harbor now enjoy greater protection in the Second Circuit. The *Tribune* decision is also the latest in a string of Second Circuit decisions broadly construing the securities contract safe harbor, so market participants who rely heavily on the safe harbors should see this decision as another positive sign.

² The Second Circuit also reversed the district court on standing grounds, holding that the individual creditors did have standing to sue the shareholders in state or federal courts because the bankruptcy court had granted the individual creditors relief from the automatic stay specifically to commence the state law constructive fraudulent transfer claims.

³ In *Picard v. Ida Fishman Revocable Trust (In re Bernard L. Madoff Investment Securities LLC)*, 773 F.3d 411 (2d Cir. 2014), the Second Circuit noted that Section 741(7) of the Bankruptcy Code “defines ‘securities contract’ with extraordinary breadth.”

If you would like to receive future *Bankruptcy Advisories* electronically, please forward your contact information to bankruptcy.advisory@alston.com. Be sure to put "subscribe" in the subject line.

If you have questions regarding the information in this bankruptcy and restructuring update, please feel free to reach out to:

Karen Gelernt
212.210.9535
karen.gelernt@alston.com

Aimee Cummo
212.210.9428
aimee.cummo@alston.com

Shanell Cramer
212.210.9580
shanell.cramer@alston.com

Michael Calandra
212.210.9426
michael.calandra@alston.com

Will Sugden
404.881.4778
will.sugden@alston.com

Jonathan Edwards
404.881.4985
jonathan.edwards@alston.com

Lorraine Sarles
213.576.1096
lorraine.sarles@alston.com

ALSTON & BIRD

WWW.ALSTON.COM

© ALSTON & BIRD LLP 2016

ATLANTA: One Atlantic Center ■ 1201 West Peachtree Street ■ Atlanta, Georgia, USA, 30309-3424 ■ 404.881.7000 ■ Fax: 404.881.7777
BEIJING: Hanwei Plaza West Wing ■ Suite 21B2 ■ No. 7 Guanghua Road ■ Chaoyang District ■ Beijing, 100004 CN
BRUSSELS: Level 20 Bastion Tower ■ Place du Champ de Mars ■ B-1050 Brussels, BE ■ +32 2 550 3700 ■ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ■ 101 South Tryon Street ■ Suite 4000 ■ Charlotte, North Carolina, USA, 28280-4000 ■ 704.444.1000 ■ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ■ 18th Floor ■ Dallas, Texas, USA, 75201 ■ 214.922.3400 ■ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ■ 16th Floor ■ Los Angeles, California, USA, 90071-3004 ■ 213.576.1000 ■ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ■ 15th Floor ■ New York, New York, USA, 10016-1387 ■ 212.210.9400 ■ Fax: 212.210.9444
RESEARCH TRIANGLE: 4721 Emperor Blvd. ■ Suite 400 ■ Durham, North Carolina, USA, 27703-85802 ■ 919.862.2200 ■ Fax: 919.862.2260
SILICON VALLEY: 1950 University Avenue ■ 5th Floor ■ East Palo Alto, California, USA, 94303-2282 ■ 650.838.2000 ■ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ■ 950 F Street, NW ■ Washington, DC, USA, 20004-1404 ■ 202.239.3300 ■ Fax: 202.239.3333