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the Section 546(e) safe harbor when a financial institution is nothing more than a conduit. The contrasting approaches in appellate decisions leave the bankruptcy courts struggling to adopt consistent positions on the scope of safe harbor protections. Unless and until the U.S. Supreme Court is ready, willing, and able to calm the storm and provide the certitude that Congress intended for the safe harbor to provide, parties to transactions like those addressed in *Lyondell* and *FTI* may find themselves exposed to clawback risk despite the language of the safe harbors, depending on where a bankruptcy case is filed.

# Delaware Bankruptcy Court Declines to Follow Second Circuit and Holds Safe Harbors Do Not Apply to Some State Law Fraudulent Conveyance Claims

*By Jason W. Harbour\**

*This article discusses a recent bankruptcy court decision holding that Section 546(e) safe harbors do not prevent a liquidation trust from pursuing some state law constructive fraudulent conveyance claims assigned to the trust by creditors.*

The Bankruptcy Court for the District of Delaware recently held that the Bankruptcy Code Section 546(e) safe harbors do not prevent a liquidation trust from pursuing some state law constructive fraudulent conveyance claims assigned to the trust by creditors.<sup>1</sup> Notably, the bankruptcy court declined to follow the U.S. Court of Appeals for the Second Circuit's recent *Tribune* decision, in which the Second Circuit concluded that the Section 546(e) safe harbors apply to state law constructive fraudulent conveyance claims on federal preemption grounds.<sup>2</sup> Instead, the bankruptcy court decided that federal preemption did not apply to the claims at issue because the transaction did not pose ripple effects in the relevant markets, the securities were nonpublic, and the transferees were corporate insiders that allegedly acted in bad faith.<sup>3</sup> Although defendants in *Physiotherapy* seek to appeal the decision, *Physiotherapy* underscores the fact that *Tribune* did not foreclose the possibility of creditors or liquidating trusts pursuing state law constructive fraudulent transfer claims outside the Second Circuit, even if Section 546(e) would bar such claims if brought under Bankruptcy Code Section 544.<sup>4</sup>

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<sup>1</sup> See *PAH Litigation Trust v. Water Street Healthcare Partners L.P., et al. (In re Physiotherapy Holdings, Inc., et al.)*, No. 13-12965, AP No. 15-51238 (Bankr. D. Del. June 20, 2016) [Doc. No. 250] ("*Physiotherapy*").

<sup>2</sup> See *Deutsche Bank Trust Co. Ams. v. Large Private Beneficial Owners (In re Tribune Co. Fraudulent Conveyance Litigation)*, 818 F.3d 98 (2d Cir. 2016) ("*Tribune*").

<sup>3</sup> See *Physiotherapy*, No. 13-12965, AP No. 15-51238, at 22.

<sup>4</sup> See *PAH Litigation Trust v. Water Street Healthcare Partners L.P., et al. (In re Physiotherapy*

## GENERAL BACKGROUND

Section 546(e) of the Bankruptcy Code provides safe harbor defenses for certain preference and constructive fraudulent transfer claims brought under, *inter alia*, Bankruptcy Code Sections 544, 547, or 548(a)(1)(B), though Section 546(e) expressly excludes from coverage avoidance actions for intentional fraudulent transfers under Section 548(a)(1)(A).<sup>5</sup> In particular, Section 546(e) protects transfers to covered parties that are margin payments or settlement payments, or transfers to covered parties that are made in connection with a securities contract.<sup>6</sup>

Prior to *Tribune*, courts within the Second Circuit had reached different results regarding federal preemption and the application of the Bankruptcy Code safe harbors to state law constructive fraudulent transfer claims. In June 2013, the District Court for the Southern District of New York held that the safe harbors impliedly preempt creditors' state law fraudulent conveyance claims assigned to a liquidating trust.<sup>7</sup> Specifically, in *Whyte*, the district court held that federal preemption applies and that Bankruptcy Code Section 546(g), which provides safe harbor protections to swap agreements similar to the safe harbor protections Section 546(e) provides to securities contracts, prevents a liquidation trust from pursuing state law constructive fraudulent transfer claims assigned to the trust by creditors.<sup>8</sup>

A few months later, in September 2013, the District Court for the Southern District of New York reached a different result and concluded that federal

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*Holdings, Inc., et al.*, No. 13-12965, AP No. 15-51238 (Bankr. D. Del. July 15, 2016) [Doc. Nos. 255, 256].

<sup>5</sup> See 11 U.S.C. § 546(e). Bankruptcy Code Section 546(e) states as follows:

Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is 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, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

<sup>6</sup> See *id.*; *Picard v. Ida Fishman Revocable Trust (In re Bernard L. Madoff Investment Securities LLC)*, 773 F.3d 411, 418 (2d Cir. 2014).

<sup>7</sup> See *Whyte v. Barclays Bank PLC*, 494 B.R. 196 (S.D.N.Y. 2013) ("*Whyte*").

<sup>8</sup> See *id.* at 200–01.

preemption and Section 546(e) do not apply to state law constructive fraudulent transfer claims in the *Tribune* matter.<sup>9</sup> The district court based its decision, in part, on the argument that the claims at issue were brought on behalf of creditors, while Section 546(e) states that the “trustee” may not avoid certain transfers.<sup>10</sup>

Shortly after the district court’s ruling in the *Tribune* matter, in January 2014, the Bankruptcy Court for the Southern District of New York reached a similar result in *Lyondell*, concluding that federal preemption and Section 546(e) do not prohibit state law constructive fraudulent transfer claims brought on behalf of creditors.<sup>11</sup> The *Lyondell* bankruptcy court’s decision also was based, in part, on the argument that the claims were brought on behalf of creditors, while Section 546(e) uses the word “trustee.”<sup>12</sup>

In *Tribune*, the Second Circuit disagreed with the reasoning of the *Tribune* district court and the *Lyondell* bankruptcy court, and concluded that federal preemption applies and that Section 546(e) bars state law constructive fraudulent conveyance claims.<sup>13</sup> Contemporaneously with the *Tribune* decision, the Second Circuit affirmed the decision of the district court in *Whyte* concerning the Section 546(g) safe harbor for substantially similar reasons to those stated in *Tribune*.<sup>14</sup>

## ***PHYSIOTHERAPY***

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.<sup>15</sup> After the transaction closed, Physiotherapy’s new owners investigated accounting disparities, and Physiotherapy’s income and adjusted EBITDA deterio-

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<sup>9</sup> See *In re Tribune Co. Fraudulent Conveyance Litigation*, 499 B.R. 310 (S.D.N.Y. 2013). Although the district court concluded that Section 546(e) did not bar the claims, the district court dismissed the claims on grounds related to the automatic stay.

<sup>10</sup> See *id.* at 316–20.

<sup>11</sup> See *Weisfelner v. Fund 1 (In re Lyondell Chem. Co.)*, 503 B.R. 348 (Bankr. S.D.N.Y.) (“*Lyondell*”).

<sup>12</sup> See *id.* at 359–78.

<sup>13</sup> See *Tribune*, 818 F.3d at 109–124.

<sup>14</sup> See *Whyte v. Barclays Bank PLC*, No. 13-2653, 2016 U.S. App. LEXIS 5465 (2d Cir. Mar. 24, 2016).

<sup>15</sup> See *Physiotherapy*, No. 13-12965, AP No. 15-51238, at 8.



rated.<sup>16</sup> 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.<sup>17</sup>

The PAH Litigation Trust (the "Trust") asserted numerous claims in the adversary proceeding against the selling shareholders, including intentional fraudulent transfer claims, federal law constructive fraudulent transfer claims, and state law constructive fraudulent transfer claims.<sup>18</sup> With respect to the Trust's federal law constructive fraudulent transfer claims, the *Physiotherapy* court held that the Section 546(e) safe harbors applied, that the transfers were settlement payments in connection with a securities contract, and that there is no exception to the safe harbors for insiders who allegedly act in bad faith.<sup>19</sup> With respect to the state law constructive fraudulent transfer claims, however, which the Trust asserted as the assignee of creditors, the *Physiotherapy* court held that federal preemption and Section 546(e) do not apply.<sup>20</sup>

The *Physiotherapy* court began its analysis of preemption and the application of the safe harbors to state law constructive fraudulent conveyance claims by discussing prior cases, including *Whyte*, *Lyondell*, and the district court and Second Circuit *Tribune* decisions.<sup>21</sup> The *Physiotherapy* court found the reasoning in the bankruptcy court's *Lyondell* decision more persuasive than the Second Circuit's *Tribune* decision, and adopted the *Lyondell* holding.<sup>22</sup>

The *Physiotherapy* court then concluded that the "presumption against preemption" applies to the analysis of whether Section 546(e) preempts state law constructive fraudulent transfer claims, stating that "the Court believes that the *Lyondell* decision correctly recognized that the States have traditionally occupied the field of fraudulent transfer law, and applying the presumption against preemption is therefore appropriate."<sup>23</sup> The *Physiotherapy* court did not address the Second Circuit's analysis of the presumption against preemption issue.<sup>24</sup> Specifically, in *Tribune*, the Second Circuit concluded that the presumption against preemption does not apply to the analysis of whether

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<sup>16</sup> See *id.* at 8–9.

<sup>17</sup> See *id.* at 9.

<sup>18</sup> See *id.* at 9–10.

<sup>19</sup> See *id.* at 22–26.

<sup>20</sup> See *id.* at 9, 11–22.

<sup>21</sup> See *id.* at 11–16.

<sup>22</sup> See *id.* at 16.

<sup>23</sup> *Id.* at 16.

<sup>24</sup> See *id.* at 16.

Section 546(e) preempts state law constructive fraudulent transfer claims because “there is no measurable concern about federal intrusion into traditional state domains. Our bottom line is that the issue before us is one of inferring congressional intent from the Code, without significant countervailing pressures of state law concerns.”<sup>25</sup> In reaching this conclusion, the Second Circuit noted that the presumption against preemption is strongest in areas traditionally recognized as areas of state law, and that “[t]o understate the proposition, the regulation of creditors’ rights has a history of significant federal presence.”<sup>26</sup> The Second Circuit also noted that creditors’ state law fraudulent transfer claims were preempted upon the bankruptcy filing, and that a disposition of a state law fraudulent transfer claim brought by a trustee under Bankruptcy Code Section 544 would have extinguished the rights of creditors to bring such state law fraudulent conveyance claims.<sup>27</sup>

After concluding that the presumption against preemption applies, the *Physiotherapy* court addressed whether Section 546(e) preempts state law constructive fraudulent transfer claims by discussing three issues: (i) the policies behind the safe harbors; (ii) the “trustee” argument; and (iii) the alleged bad faith of the defendants.<sup>28</sup>

First, with respect to the policies underlying the safe harbors, the *Physiotherapy* court stated that “both the written decisions and legislative history suggest that sections 546(e) and 546(g) were enacted to further augment the protections against systemic risk codified in the initial safe harbors.”<sup>29</sup> The *Physiotherapy* court expressly disagreed with the Second Circuit’s conclusion that one purpose of the safe harbors is promoting finality for individual investors.<sup>30</sup> Instead, the *Physiotherapy* court concluded that mitigating systemic risk is the purpose of the safe harbors.<sup>31</sup> Based on this conclusion, the *Physiotherapy* court reasoned that the state law constructive fraudulent transfer claims involving nonpublic securities at issue in *Physiotherapy* were not an obstacle to the policies underlying the safe harbors because avoiding the transfers would not have a ripple effect or a destabilizing effect on financial

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<sup>25</sup> *Tribune*, 818 F.3d at 112.

<sup>26</sup> *Id.* at 111.

<sup>27</sup> *See id.* at 111–12.

<sup>28</sup> *See Physiotherapy*, No. 13-12965, AP No. 15-51238, at 16–22.

<sup>29</sup> *Id.* at 18.

<sup>30</sup> *See id.* at 18–19; *Tribune*, 818 F.3d at 120–23.

<sup>31</sup> *See Physiotherapy*, No. 13-12965, AP No. 15-51238, at 18–19.

markets.<sup>32</sup>

Second, the *Physiotherapy* court addressed the argument that Section 546(e) does not bar the state law constructive fraudulent conveyance claims because the claims are brought on behalf of creditors, not on behalf of the “trustee.”<sup>33</sup> The *Physiotherapy* court noted that other provisions of the Bankruptcy Code expressly apply to parties other than the trustee, and expressly preempt state law by incorporating phrases such as “notwithstanding any applicable law.”<sup>34</sup> The *Physiotherapy* court, however, did not explicitly address the Second Circuit’s analysis of the “trustee” argument.<sup>35</sup> In *Tribune*, the Second Circuit noted, among other things, that “appellants’ theory hangs on the ambiguous use of the word ‘trustee,’ has no basis in the language of the Code, leads to substantial anomalies, ambiguities and conflicts with the Code’s procedures, and, most importantly, is in irreconcilable conflict with the purposes of Section 546(e).”<sup>36</sup> In addition, with respect to the argument that certain provisions of the Bankruptcy Code expressly apply to parties other than the trustee, the Second Circuit stated that this argument “suffers from a fatal flaw, however. In *Arizona v. United States*, the U.S. Supreme Court made clear that ‘the existence of an express pre-emption provisio[n] does not bar the ordinary working of conflict pre-emption principles or impose a special burden that would make it more difficult to establish the preemption of laws falling outside the clause.’”<sup>37</sup>

Third, the *Physiotherapy* court indicated that the alleged bad faith of the defendants “implicated additional policy concerns relevant to the preemption analysis” and the court did “not believe that Congress intended to protect bad-faith transferees in situations such as this.”<sup>38</sup>

In concluding its analysis of Section 546(e) and implied preemption, the *Physiotherapy* court held that:

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,

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<sup>32</sup> *See id.* at 20.

<sup>33</sup> *See id.* at 20–21.

<sup>34</sup> *See id.* at 20–21.

<sup>35</sup> *See id.* at 20–21.

<sup>36</sup> *Tribune*, 818 F.3d at 123.

<sup>37</sup> *Id.* at 123 (quoting *Arizona v. United States*, 132 S. Ct. 2492, 2504–05, 183 L. Ed. 2d 351 (2012)).

<sup>38</sup> *Physiotherapy*, No. 13-12965, AP No. 15-51238, at 21, 22.

and (3) the transferees were corporate insiders that allegedly acted in bad faith. When these three factors are present, a finding of implied preemption is inappropriate.<sup>39</sup>

## CONCLUSION

*Physiotherapy* represents a split from the Second Circuit's decision in *Tribune*, though it does so on a narrow factual predicate. While *Tribune* resolved whether Section 546(e) applies to state law constructive fraudulent transfer claims within the Second Circuit, *Physiotherapy* is an important reminder that courts outside the Second Circuit could conclude otherwise. Accordingly, parties in cases outside the Second Circuit likely will continue to litigate these issues until more decisions provide additional guidance and controlling precedent.

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<sup>39</sup> *Id.* at 22.