Pepper Hamilton LLP
Attorneys at Law

# Does Federal Bankruptcy Law Preempt State Law Fraudulent Transfer Claims Assigned to a Bankruptcy Estate Representative?


**BANKRUPTCY** | June 24, 2016

**Henry J. Jaffe** | jaffeh@pepperlaw.com
**Lesley S. Welwarth** | welwarthl@pepperlaw.com

---

## IN RECENT YEARS, CONSTRUCTIVELY FRAUDULENT TRANSFER CLAIMS ASSERTED IN BANKRUPTCY CASES, ESPECIALLY THOSE ARISING FROM LBOS AND SIMILAR SHAREHOLDER TRANSACTIONS, HAVE HIT A MAJOR ROAD BLOCK.

The U.S. Bankruptcy Court for the District of Delaware recently issued an opinion that addresses, among other issues, the question of whether section 546(e) of the Bankruptcy Code preempts certain fraudulent transfer avoidance actions brought under state law. *In re Physiotherapy Holdings Inc.*, No. 15-51238 (Bankr. D. Del. June 20, 2016).

In the case, the liquidation trustee filed an action to avoid and recover $248.6 million in payments made pre-petition to private equity shareholders in exchange for their equity in Physiotherapy Holdings, Inc. through a 2012 leveraged buyout transaction (LBO).

The trustee's complaint asserted that secured notes issued by the purchaser's merger subsidiary to finance the sale of Physiotherapy (whose note obligations were ultimately assumed by the debtor as part of the LBO) were issued pursuant an offering memorandum created by Physiotherapy's controlling shareholders, who fraudulently and grossly overstated Physiotherapy's revenue stream and overall firm value. The complaint alleged that, through the LBO, "Physiotherapy incurred a massive amount of new debt — predicated on false financials — the proceeds of which were transferred out to Physiotherapy's former owners without receiving anything of value in return."

In other words, the transaction allegedly worked a constructive fraud upon Physiotherapy's creditors by saddling the surviving entity with substantial secured debt that it could not satisfy, while handsomely paying out the debtor's former shareholders for selling their interests in the company. These alleged constructively fraudulent transactions (transactions made in exchange for less than reasonably equivalent value by an insolvent debtor) are generally avoidable (*i.e.*, may be unwound) by a trustee, debtor or bankruptcy estate representative in bankruptcy (an Estate Representative) under either section 548(a)(1)(B) (which contains standalone fraudulent transfer avoidance provisions) or section 544(b)(1) of the Bankruptcy Code (which permits an Estate Representative to assert fraudulent transfer claims arising under state law). Section 544(b)(1), in particular, allows an Estate Representative essentially to step into the shoes of unsecured creditors and assert state law fraudulent transfer claims that belonged exclusively to the creditors prior to bankruptcy.

## Constructive Fraud Claims and Safe Harbor Provisions

In recent years, constructively fraudulent transfer claims asserted in bankruptcy cases, especially those arising from LBOs and similar shareholder transactions, have hit a major road block. These constructive fraud claims are often barred by the so-called "safe harbor" provisions of the Bankruptcy Code, including section 546(e) of the Bankruptcy Code. Section 546(e) precludes actions to avoid transfers that are settlement payments made by or to a financial institution and transfers made by or to a financial institution in connection with a securities contract. Section 546(e) has frequently been invoked to shield shareholders who receive buy-out "settlement" payments in LBO and similar transactions.

Parties harmed by these allegedly improper transactions, however, continue to search for "work arounds" to assert constructive fraud claims in bankruptcy cases that will not be

barred by the safe harbor provisions. One strategy employed by such parties is to have creditors assign their **direct fraudulent transfer claims** back to the Estate Representative. In this way, the Estate Representative is asserting the claims in its capacity as an assignee of creditors (which arguably is not subject to the safe harbor provisions) and not in its capacity as a trustee or an Estate Representative asserting claims under sections 548 or 544 of the Bankruptcy Code (which clearly is subject to the safe harbors).

Certainly, this is a clever strategy. But the question is whether it works under the law. More to the point, the critical issue is whether these assigned non-bankruptcy state law constructively fraudulent transfer actions (which, in substance, are **identical** to the same causes of action that the estate once held but were subject to the safe harbor provisions) are preempted under federal law such that they are barred under section 546(e) or other safe harbor provisions.

## ***Physiotherapy*** **Opinion**

In *Physiotherapy*, the defendant shareholders filed a motion to dismiss, arguing, in part, that the trustee's complaint failed to state a claim because Bankruptcy Code section 546(e) fully protects the shareholders, as transferees, from the trustee's avoidance of the payments related to Physiotherapy's LBO and, further, that this provision preempts inconsistent state law (which does not contain any safe harbor protections).

The trustee countered that section 546(e) is inapplicable to the state law fraudulent transfer claims that were assigned by the creditors to the post-confirmation litigation trust. The court therefore needed to determine whether federal Bankruptcy Code section 546(e) preempts fraudulent transfer state law with respect to the trustee's claims.

This issue is one that recently has received a fair bit of attention due to a split among bankruptcy and appellate courts. Most recently, the U.S. Court of Appeals for the Second Circuit in *In re Tribune Co. Fraudulent Conveyance Litigation* affirmed the district court's dismissal of state law constructive fraudulent transfer claims against a debtor's former shareholders who were cashed out of an LBO transaction pursuant to section 546(e). 2016 U.S. App. LEXIS 5543 (2d Cir. Mar. 24, 2016). The *In re Tribune* court concluded that the safe harbor provision "shields from avoidance proceedings . . . transfers by or to financial intermediaries effectuating settlement payments in securities transactions" and therefore held that section 546(e) preempted state fraudulent transfer law. *Id.*

But the Delaware bankruptcy court declined to follow the Second Circuit's lead and instead concurred with the Southern District of New York Bankruptcy Court's *Lyondell* decision (which, in the Second Circuit, is no longer good law). *In re Lyondell Chem. Co.*,

503 B.R. 348, 372-73 (Bankr. S.D.N.Y. 2014), as corrected (Jan. 16, 2014). In *Lyondell*, the bankruptcy court recognized the presumption that "the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress" and that, because "the States have traditionally occupied the field of fraudulent transfer law," "applying the presumption against preemption is therefore appropriate." In *Lyondell*, the court found section 546(e) inapplicable as to "LBO payments to stockholders at the very end of the asset transfer chain, where the stockholders are the ultimate beneficiaries of the constructively fraudulent transfers, and can give the money back to injured creditors with no damage to anyone but themselves." *Id.*

The Delaware bankruptcy court similarly found that policy reasons supported its finding that preemption was inappropriate. As was the case in *Lyondell*, the *Physiotherapy* court found that permitting the trustee to pursue the state law fraudulent transfer claims (which do not involve, for example, any swap transactions or commodities trading, but which, here, involved transactions with non-publicly traded securities) would not implicate the concerns that the safe harbor provisions are to meant to protect, *i.e.*, transactions that have a destabilizing "ripple effect" on the financial markets. The court also seemed to be swayed (at least in part) by the alleged bad faith of the shareholders, who purportedly controlled the debtor and its board of directors and, therefore, may have been involved with or authorized the wrongdoing alleged in the complaint.

The court clarified that section 546(e) would not prevent the trustee from asserting 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."

The court also allowed the trustee's federal and state intentional fraudulent transfer claims to proceed (such claims are expressly not subject to the Bankruptcy Code's safe harbor provisions) and dismissed the Trustee's remaining constructive fraudulent transfer claims brought under sections 544 and 548 of the Bankruptcy Code (as these claims were shielded by section 546(e)).

The implications of the Delaware bankruptcy court's noteworthy departure from the Second Circuit's *Tribune* decision is an interesting development and one that is likely to spark further debate and litigation, including, perhaps, an appeal to the Third Circuit Court of Appeals.