Presented:
32nd Annual Jay L. Westbrook Bankruptcy Conference

November 20-22, 2013
Austin, TX

The Future of Fraudulent Transfer Litigation

Part 1

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I. Introduction

The number and size of highly leveraged transactions in recent years has resulted in significant fraudulent transfer litigation. During the credit boom that started in 2003 and peaked in 2007, banks and bondholders financed many highly leveraged transactions. In 2007 alone, more than $4.1 trillion in new loans were made, nearly $2.7 trillion of which were leveraged loans.[1] From 2004 to 2008, there was a total of over $15.5 trillion in new loans, $8.4 trillion of which were leveraged loans. As the debts became due and businesses struggled to refinance their debts, there was a wave of defaults, bankruptcies and intercreditor disputes. Many significant fraudulent transfer cases involving high dollar disputes ensued.[2]

These materials discuss recent developments which have grown out of this litigation, including the safe harbor of Bankruptcy Code section 546(e) and related preemption issues, the collapsing doctrine, and damage limitations. The following discussion addresses how recent decisions have resolved these complex issues and the implications of these cases for future litigation.

II. Issues Unique to Fraudulent Transfer Litigation

A. Bankruptcy Code Section 546(e) Safe Harbor and Preemption

Fraudulent transfers can be avoided by a bankruptcy trustee or chapter 11 debtor-in-possession under either: (i) section 548 of the Bankruptcy Code, which creates a federal cause of action for avoidance of transfers made or obligations incurred up to two years before a bankruptcy filing; or (ii) section 544(b) of the Bankruptcy Code, which gives the trustee or debtor-in-possession the power to avoid a fraudulent transfer of property that would be voidable under state law by a creditor holding an allowable unsecured claim.[3]

Section 546 of the Bankruptcy Code imposes a number of limitations on these avoidance powers. Specifically, section 546(e) prohibits, with certain exceptions, avoidance of constructive fraudulent transfers which are margin or settlement payments made in connection with securities,

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1 *See* Thomson Source: Thomson Financial Syndicated Loans Database (1983-2009).

2 *See, e.g.*, *Picard v. Fairfield Greenwich Ltd.,* 762 F.3d 199, 203, 204 (2d Cir. 2014) (trustee instituted fraudulent conveyance claims against various defendants for almost $4 billion); *Citicorp N. Am., Inc. v. Official Comm. of Unsecured Creditors (In re TOUSA, Inc.)*, 680 F.3d 1298, 1301 (11th Cir. 2012) (affirming liability findings of the bankruptcy court which avoided liens as a fraudulent transfer and ordered lenders to disgorge $403 million of a loan); *Weisfelner v. Fund 1 (In re Lyondell Chem. Co.)*, 503 B.R. 348, 353 (Bankr. S.D.N.Y. 2014), as corrected (Jan. 16, 2014) (creditor trust seeking to recover approximately $6.3 billion in payments); *Tronox Inc. v. Kerr-McGee Corp. (In re Tronox Inc.)*, 503 B.R. 239 (Bankr. S.D.N.Y. 2013) (court concluding that the spin-off of a chemical business constituted a fraudulent transfer intended to shield the business from environmental liabilities, and requesting further briefing on the issue of damages to determine whether they should be approximately $5 billion or $14.5 billion); *In re Tribune Co. Fraudulent Conveyance Litig.*, 499 B.R. 310, 313 (S.D.N.Y. 2013) (fraudulent conveyance claims brought in connection with leveraged buyout that paid out more than $8.2 billion to public shareholders).

3 Section 544(b) of the Bankruptcy Code provides that "[e]xcept as provided in paragraph (2), the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title." 11 U.S.C. § 544.

commodity, or forward contracts.[4] The purpose of section 546(e) and the Bankruptcy Code's other financially focused "safe harbors" is to minimize "systemic risk" to the securities and commodities markets which could be caused by a financial contract counterparty's bankruptcy filing. Similar to sections 544 and 548, section 546(e) is expressly directed at a bankruptcy trustee or, pursuant to section 1107(a), a debtor-in-possession, and provides "[n]otwithstanding 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 . . . or settlement payment . . . . . "[5]

The decision of the Court of Appeals for the Second Circuit in *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V. (In re Enron Creditors Recovery Corp.)* expanded the scope of this defense, which is now being applied to preclude recovery in fraudulent transfer actions. In *Enron*, the Second Circuit held that courts should look to section 546(e)'s plain language rather than its legislative history in determining whether section 546(e) protects a transfer from avoidance.[6] By focusing on the plain language of the statute, the Second Circuit expanded application of section 546(e) in a manner that the dissenting judge described as "extraordinarily broad."[7]

Enron had three important implications. First, the decision made clear that the phrase "commonly used in the securities trade," only modified the last clause of section 741(8), thereby expanding the definition of a settlement payment covered by section 546(e).[8] Bankruptcy Code section 741(8) defines a settlement payment as "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." The court found that the phrase "commonly used in the securities industry" is properly read as modifying only the term "any other similar payment" and not each of the preceding enumerated forms of payments which the definition includes as settlement payments.[9] If such phrase were read to modify the entire definition, then the application of the safe harbor would depend on a factual determination regarding the commonality of a given transaction in every case, leading to

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4 Section 546(e) of the Bankruptcy Code provides:

> 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.
>
> 11 U.S.C. § 546.

5 *Id.* (emphasis added).

6 *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V., ING VP*, 651 F.3d 329, 335 (2d Cir. 2011).

7 *Id*. at 347 (Koeltl, D.J., dissenting).

8 *Id*. at 335-36.

9 *Id*. 336 (citations omitted).

Title search: The Future of Fraudulent Transfer Litigation – Part 1

First appeared as part of the conference materials for the
33rd Annual Jay L. Westbrook Bankruptcy Conference session
"Future of Fraudulent Transfer Litigation"