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State Law Fraudulent Transfer Claims: Reversion to Individual Creditors

Bringing and Defending Claims Abandoned by the Trustee or Estate

THURSDAY, OCTOBER 25, 2012

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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State Law Fraudulent Transfer Claims: Reversion to Individual Creditors; *Lyondell* and *Tribune* Case Review

By: Arthur Steinberg & Christopher Boies

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PART ONE

THE *LYONDELL* AND *TRIBUNE* CASES

Lyondell

Quick Facts of LyondellBasell Industries ("LBI")

- Lyondell Chemical Company ("Lyondell"), a chemicals manufacturer and petroleum refiner, entered into a merger agreement with Basell AF S.C.A. ("Basell") on July 16, 2007.
- The merger, which closed on December 20, 2007, created LBI, one of the world's largest oil refiners and polymers and petrochemical producers.
- The company filed for Chapter 11 protection on January 6, 2009.

Lyondell

The LBO

- Basell was an international chemicals company controlled by Leonard Blavatnik.
- Blavatnik made several offers for Lyondell's shares over a couple of years.
- In May 2007, Blavatnik acquired 21 million shares of Lyondell stock and disclosed in his SEC filing that he might seek to acquire all of Lyondell's outstanding stock.
- Basell agreed to purchase Lyondell in a leveraged buyout for $48 per share in July 2007.
- Lyondell shareholders received $12.5 billion.

Lyondell

Fraudulent Transfer Issues

- In July 2009, the Creditors Committee sued the lenders that financed the buyout, Lyondell's and LBI's former directors and officers, and Blavatnik and related entities.
- In the same action, the Creditors Committee sued Barclays Global Investors, N.A. ("BGI") individually and as class representative of the shareholder class.
- A case management order split the litigation into three phases, with the BGI claim deferred for adjudication as part of Phase II.

Lyondell

Fraudulent Transfer Issues (continued)

- In a settlement approved by the Bankruptcy Court in March 2010, the Debtor settled with the LBO lenders for $450 million.
- In April 2010, the Bankruptcy Court confirmed a plan of reorganization (the “Plan”). Subsequently, the Creditors Committee amended its complaint, removing the claim against BGI and the former shareholders.
- Under the Plan, a creditor trust was created to litigate state law avoidance actions against the former Lyondell shareholders, which claims were treated as having been abandoned by the Creditors Committee.

Lyondell

Fraudulent Transfer Issues (continued)

- On October 22, 2010, the trustee of the creditor trust filed a lawsuit against former Lyondell shareholders, asserting only state-law fraudulent conveyance claims under "Applicable State Fraudulent Transfer Law," in the Supreme Court of the State of New York, County of New York.
- On November 22, 2010, certain of the shareholder defendants removed the case to the United States Court for the Southern District of New York.
- On December 1, 2010, the case was referred to the United States Bankruptcy Court for the Southern District of New York, which is administering the Lyondell bankruptcy case.
- The Bankruptcy Court entered an order on June 3, 2011 that allows the trustee of the creditor trust to amend its complaint to add defendants without leave of the court.
- On December 13, 2011, and again on December 19, 2011, the trustee of the creditor trust filed amended complaints to add defendants.

Lyondell

Fraudulent Transfer Issues (continued)

- Several motions to dismiss have been filed in response to the trustee's complaint.
- The Bankruptcy Court heard arguments regarding dismissal on May 12, 2011.
- The defendants make the federal preemption argument discussed later in this presentation.
- The Bankruptcy Court has yet to rule on the dismissal motions and the suit against the former Lyondell shareholders remains pending.

Tribune Company

Quick Facts of Tribune Company ("Tribune")

- Tribune is a media conglomerate, which owns 23 TV stations and 12 newspapers, including the Chicago Tribune and the Los Angeles Times, as well as the Chicago Cubs baseball team.
- Investors led by Chicago real estate developer Samuel Zell took control of Tribune in a two-step LBO transaction in 2007.
- Tribune and certain of its subsidiaries filed for Chapter 11 protection on December 8, 2008.

Tribune Company

The LBO

- In April 2007, allegedly under pressure to cash out some of its major shareholders, the board of Tribune approved an LBO proposal by Zell to take the company private.

- In connection with the LBO, ownership of Tribune and its subsidiaries was transferred to a newly formed employee stock ownership plan (“ESOP”).

Tribune Company

The LBO (continued)

- "Step One" of the LBO closed on June 4, 2007, and involved the purchase by the ESOP of shares of Tribune common stock and the consummation by Tribune of a cash offer for nearly 50% of its outstanding common stock. These Step One Shareholders received approximately $4.3 billion for their shares.
- "Step Two" of the LBO closed in December 2007, and involved Tribune cashing out its remaining shareholders and merging with a Delaware corporation wholly-owned by the ESOP, with Tribune being the surviving entity. These Step Two Shareholders received approximately $4 billion for their shares.
- To finance the transaction, Zell caused Tribune to increase its debt load from $5.3 billion to $14 billion.

Tribune Company

Fraudulent Transfer Issues

- Pursuant to the two-year statute of limitations imposed by Section 546(a) of the Bankruptcy Code for a bankruptcy estate representative to bring fraudulent transfer actions, the Debtors and, if applicable, the Creditors Committee had until December 8, 2010 to commence, among other claims, state law constructive fraudulent transfer claims under Section 544(b) of the Bankruptcy Code against former shareholders who had tendered shares in connection with the LBO. No actions were brought within such time against the shareholders who tendered shares in the LBO.

Tribune Company

Fraudulent Transfer Issues (continued)

- On March 1, 2011, a group of Tribune bondholders filed a motion with the Bankruptcy Court (the "Motion") seeking permission to file lawsuits against former Tribune shareholders who had tendered shares in connection with the LBO.
- The statute of limitations for commencing a creditor's state law fraudulent transfer action is determined by applicable state law. For example, New York has a six-year statute of limitations period.
- The Tribune bondholders argued that the state law in the following states may be implicated in a state law fraudulent transfer action: Delaware (the state of incorporation of Tribune), Illinois (the Debtors' principal place of business), and Massachusetts (the state where Step One shareholders tendered their Tribune stock in exchange for payment). Each of these states has a four-year statute of limitations for fraudulent transfer claims.
- As such, the Motion was filed before the four year anniversary of the closing of Step One of the LBO (June 4, 2011).

Tribune Company

<u>Fraudulent Transfer Issues (continued)</u>

- On April 25, 2011, the Bankruptcy Court noted that, since no state law constructive fraudulent conveyance claims had been brought by or on behalf of the Bankruptcy Estate against former shareholders who had tendered their shares in connection with the LBO before the expiration of the two-year statute of limitations under Section 546(a) of the Bankruptcy Code, the creditors arguably may have regained the right to pursue state law constructive fraudulent conveyance claims against such former shareholders and to seek recovery of payments made to such shareholders in connection with the LBO. The Court's actual language in the order is murky on this point. Defendants in the subsequently commenced cases do not believe the Court rendered a ruling on the reversionary point.
- The Bankruptcy Court lifted the automatic stay to permit the creditors to file lawsuits against the former shareholders with the condition that those actions would then be automatically stayed, pending the outcome of the contested confirmation hearings.

Tribune Company

Fraudulent Transfer Issues (continued)

- On July 23, 2012, a reorganization plan proposed by Tribune and its largest creditors was approved by the Bankruptcy Court, overruling objections brought by numerous parties; junior creditors asked the judge to stay consummation of a restructuring plan that would hand ownership of Tribune to its senior creditors
- On August 22, 2012, the judge granted a stay of the confirmation order pending an appeal, which was conditioned on Aurelius Capital Management and other junior creditors posting a bond of $1.5 billion by August 29, 2012.
- On September 10, 2012, an appeal by Aurelius Capital Management to stay entry of the confirmation order without posting a required $1.5 billion bond was dismissed by the 3rd Circuit Court of Appeals.

Tribune Company

Fraudulent Transfer Issues (continued)

- On December 20, 2011, the U.S. Judicial Panel on Multidistrict Litigation consolidated 44 fraudulent conveyance suits brought by Deutsche Bank Trust Co. Americas and others against former Tribune shareholders.
- The consolidated cases had been filed in 21 states against more than 1,700 former Tribune shareholder defendants.
- On December 28, 2011, the consolidated cases were stayed due to Tribune's bankruptcy, pending further order of the Bankruptcy Court for the District of Delaware or the United States District Court for the Southern District of New York.

Tribune Company

Fraudulent Transfer Issues (continued)

- On July 13, 2012, the Southern District of New York approved a case management structure proposed in the April 20, 2012 Report by Defendant's Liaison Counsel and established a two-phase briefing for motions to dismiss. The two phases are outlined as followed:
  - **The Phase-One Omnibus Motion**: Section 546(e) and related preemption and standing arguments that, if successful, will result in dismissal of the fraudulent transfer actions in their entirety.
  - **The Phase-Two Motions:** If the Court denies the Phase-One Omnibus Motion, a schedule would be established for the briefing and argument of Phase-Two Motions. Phase-Two Motions would seek dismissal on various grounds, not necessarily applicable to all defendants, including: (i) certain defendants are mere conduits, (ii) certain public entity defendants are immune from liability under the doctrine of sovereign immunity, (iii) certain defendants are immune from liability under provisions of ERISA or under the Investment Advisors Act of 1940, and (iv) that the Court does not have personal jurisdiction over certain defendants.
- On October 2, 2012, the Plaintiffs offered to compromise and settle the claims asserted against certain defendants in exchange for payment of less than the full amount of those claims. Plaintiffs' settlement offer proposes that the Defendants pay, as applicable, 20% of their exposure with respect to Step One of the LBO and 40% of their exposure with respect to Step Two of the LBO in return for a mutual release of claims. The Plaintiffs' settlement offer noted that it will expire on November 16, 2012 at 4:00 p.m. ET.

PART II

WHAT ARGUMENTS CAN BE MADE IN FAVOR OR AGAINST THE ALLEGED REVERSION OF FRAUDULENT TRANSFER CLAIMS TO CREDITORS?

Right to Bring Fraudulent Transfer Claims in Bankruptcy

- Section 362 of the Bankruptcy Code automatically prevents creditor action against the debtor or its property.
- Section 544 of the Bankruptcy Code provides that the bankruptcy estate representative has the right to bring fraudulent transfer claims under state law after a bankruptcy filing.
- Section 548 is the federal bankruptcy fraudulent transfer statute. It is similar in many respects to state law fraudulent transfer claims.

Right to Bring Fraudulent Transfer Claims in Bankruptcy

- Section 546(a) of the Bankruptcy Code requires that fraudulent transfer claims be brought by the bankruptcy estate representative within the two-year period following the commencement of the bankruptcy case.
- During the two-year period, it is generally understood that only the bankruptcy estate representative, and not an individual creditor, may bring a state law fraudulent transfer claim with respect to transfers made by the debtor.
- While it is clear that after the two-year period, the bankruptcy estate representative cannot bring fraudulent transfer actions, the Bankruptcy Code is silent as to whether state law fraudulent transfer claims thereafter "revert" to individual creditors.

Property of the Estate

- There is a split of authority as to whether the ability of a bankruptcy estate representative to bring fraudulent transfer claims constitutes "property of the estate" within the meaning of Section 541 of the Bankruptcy Code.
- The Bankruptcy Code requires the bankruptcy estate representative to "fully administer" the bankruptcy estate and only authorizes closure of a bankruptcy case after the estate has been fully administered. Property of the estate generally does not automatically revert to other entities.
- Property of the estate is to be administered in the bankruptcy proceeding (by sale, abandonment or otherwise) for the benefit of all creditors.

Policy Arguments

- If (a) the bankruptcy estate representative has the exclusive right to bring a fraudulent transfer claim, (b) the bankruptcy estate representative is required to administer property of the estate, (c) there are specific provisions of the Bankruptcy Code dealing with the sale or abandonment of estate property, and (d) the Bankruptcy Code makes no mention of an automatic reversionary right to creditors, then why should there be an automatic reversion to creditors as compared to requiring the bankruptcy estate representative to "use or lose" the fraudulent transfer claim for all creditors?
- Since the Bankruptcy Code is designed to create a centralized forum for the disposition of estate property by a bankruptcy estate representative, shouldn't those issues be sorted out for fraudulent transfer claims during the first two years of a case?

Policy Arguments (continued)

- In *Tribune,* the bankruptcy estate representative brought *certain* fraudulent transfer claims against former shareholders, just not claims that would have the protection of the Section 546(e) safe harbor. Section 546(e) is discussed later in this presentation.
- If a creditor believed that the bankruptcy estate representative should have sued other parties, isn't the better policy to require that such creditor raise the issue with the bankruptcy court before the two-year statute of limitations period expires?
  - Such a policy maintains the concept of a centralized forum, and one decision maker, for the benefit of *all creditors*.
  - Seems like a better option than having some fraudulent transfer claims pending in the bankruptcy court, while multiple actions are pending in various state courts.

Cases Supporting Reversionary Rights

Klingman v. Levinson, 158 B.R. 109 (N.D. Ill. 1993)

- After bankruptcy case closed, creditors sought to set aside a conveyance of a land trust interest from the Debtor to his wife as a fraudulent transfer.
- The Debtor and his wife moved for summary judgment, arguing that the creditors' claims should be barred as creditors lacked standing once a bankruptcy petition has been filed.
- Court permitted the creditors' claims to proceed, noting that "the trustee never sought to recover the conveyance challenged… [and] the statute of limitations has long since run on the trustee's right to bring that action."

Cases Supporting Reversionary Rights (continued)

Munson v. Rinke, 919 N.E.2d 438 (Ill. App. 2009)

- After the debtor’s bankruptcy proceeding, creditors sought to set aside certain vehicle transfers from the debtor to his wife, alleging fraudulent conveyance.
- Court found that the creditors’ claims were not barred, and pointed out that “[d]uring the bankruptcy proceedings, the bankruptcy trustee was aware of the vehicle transfers and, at that time, had the exclusive right to pursue the fraudulently conveyed assets,” but did not.

Federal Preemption Arguments

<u>Section 546(e)</u>

- Section 546(e) of the Bankruptcy Code provides that a bankruptcy estate representative may not avoid a transfer that is a “settlement payment” made by or to a financial institution, stockbroker or other securities intermediary before the commencement of a bankruptcy case.
- Exception: Section 546(e) expressly provides that it does not apply to transfers with actual fraudulent intent avoidable pursuant to Section 548(a)(1)(A). This exception therefore does not apply to state law fraudulent transfer claims.
- The term “settlement payment” is broadly defined under the Bankruptcy Code, and has been held by courts to include payments to shareholders tendering shares in an LBO.

Federal Preemption Arguments

Section 546(e) - Recent Decisions

Picard v. Katz, et. al., No. 11 Civ. 2605(JSR) (S.D.N.Y. 2011)

- On September 27, 2011, Judge Jed Rakoff of the United States District Court for the Southern District of New York dismissed nine of eleven causes of action brought by Irving Picard, SIPA trustee appointed for Bernard L. Madoff Investment Securities, LLC and Bernard L. Madoff against certain defendants, including the owners of the New York Mets.
- Rakoff found that the safe harbor provisions of 546(e) served to eliminate all claims predicated on the principles of preference or federal constructive intent fraudulent transfer under the Bankruptcy Code, as well as all state law fraudulent transfer claims asserted pursuant to a bankruptcy trustee's powers under the strong-arm clause of Section 544.
- The only remaining claims were the SIPA trustee's actual intent fraudulent transfer claim under Section 548, and his equitable subordination claim.
- Judge Rakoff did not deal with the reversionary right issue since the fraudulent transfer actions were brought by the SIPA trustee within the two-year statute of limitations period.

Federal Preemption Arguments (continued)

Cases Regarding the 546(e) Federal Preemption Argument

U.S. Bank Nat'l Ass'n v. Verizon Commc'ns Inc. et al., 2012 WL 4050088 (N.D. Tex.)

- In an effort to divest itself of its ailing Yellow Pages business, Verizon Communications Inc. crafted a complex deal in which the Yellow Pages business would be spun-off to shareholders as part of a tax-free transaction and become Idearc, a standalone company.
- The spin-off occurred in November 2006, and Idearc filed for bankruptcy in March 2009. In September 2010, a litigation trust established under Idearc's plan of reorganization (which was confirmed in December 2009) brought state-law fraudulent transfer and unlawful dividend claims against Verizon Communications and certain of its subsidiaries, seeking to recover, among other things, the value of cash payments made by Idearc to its former parent company in connection with the spin-off.
- The district court, using similar logic to that employed in the Hechinger case described below, dismissed both sets of state-law claims with respect to cash transfers made by Idearc in connection with the spin-off, concluding that such claims were preempted by Section 546(e).

Federal Preemption Arguments (continued)

History of Section 546(e)

- The safe harbor provisions were first enacted in 1978 as Section 764(c) of the Bankruptcy Code, and applied exclusively to margin payments made from commodities clearing organizations and therefore only protected transfers made in the ordinary course of business in the commodities market.
- In 1982, Congress amended the safe harbor provisions, replacing 764(c) with three sections, including 546(e), to extend similar protections to the securities markets.
- The safe harbor provisions were enacted at the urging of the SEC "to minimize the displacement caused in the commodities and securities market in the event of a major bankruptcy affecting those industries" and to prevent "the undoing of possibly thousands of settled securities transactions," which could have a "potentially devastating effect."

Federal Preemption Arguments (continued)

Section 546(e) and Creditor Action

- Section 546(e) is silent concerning its applicability as a defense to fraudulent transfer claims brought by non-bankruptcy estate representatives outside the bankruptcy court.
- A federal preemption argument could be made that notwithstanding the silence, Congress intended Section 546(e) to “occupy the field” such as to leave no room for state law fraudulent transfer claims by creditors once a bankruptcy case is commenced.

Federal Preemption Arguments (continued)

Cases Supporting a 546(e) Federal Preemption Argument

- In re Hechinger Inv. Co., 274 B.R. 71 (D. Del. 2002)
- Creditors' Committee sought to recover payments made to debtor's former shareholders in an LBO, asserting both a fraudulent transfer claim under the Bankruptcy Code and an unjust enrichment claim under state common law.
- The Court rejected the attempt by the Creditors Committee to make an end-run around 546(e) by barring recovery on the state law claims of unjust enrichment. In doing so, the Court noted that permitting recovery on the state law claims would "directly conflict[] with the remedial exemption set forth in Code section 546(e)" and would "implicate the same concerns regarding the unraveling of settled securities transactions."

Federal Preemption Arguments (continued)

Cases Supporting a 546(e) Federal Preemption Argument

- Contemporary Indus. Corp. v. Frost, 564 F.3d 981 (8th Cir. 2009)
- Debtor brought claims against former shareholders seeking to recover payments they received for their stock in an LBO. The claims were brought pursuant to Section 544(b) and incorporated state fraudulent conveyance law, as well as common law theories that the payments unjustly enriched the defendants and constituted illegal/excessive shareholder distributions under state law.
- The Court held that the Debtor's claims seeking to recover payments under state law for unjust enrichment and illegal distributions were preempted, and noted that permitting recovery on the state law claims "would render the 546(e) exemption meaningless, and would wholly frustrate the purpose behind that section."

Federal Preemption Arguments (continued)

Cases Regarding the 546(e) Federal Preemption Argument

- PHP Liquidating, LLC v. Robbins, 291 B.R. 603 (D. Del. 2003)
- Pursuant to a plan of liquidation, the debtor's avoidance claims were assigned to a trust for the benefit of creditors, who were also given the option of assigning their individual claims to the trust.
- Court held to the contrary of *Hechinger* and *Contemporary Indus. Corp.* -- Section 546(e) only functions as a bar to the bankruptcy estate representative's fraudulent transfer claim, but not the claims of individual creditors. Without much discussion, the Court simply stated, "PHP LLC has not asserted its claims against [Defendants] in the capacity of a trustee or as a successor-in-interest to a trustee or debtor-in-possession. Rather, PHP LLC is bringing the instant claims as a direct assignee of the unsecured creditors. As such, Section 546(e) is not a bar to PHP LLC's claims."
- Significantly though, the result in this case was that the state law claims sought to be asserted by the creditors were dismissed because such claims could only be asserted by the bankruptcy estate representative and not the individual creditors.

PART III

Question & Answer Session

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