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Delaware Bankruptcy Court limits the scope of bankruptcy safe harbor for settlement payments in connection with a securities contract under section 546(e)

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In a decision handed down recently in *In re Physiotherapy Holdings Inc.*,[1] the U.S. Bankruptcy Court for the District of Delaware was asked to consider whether section 546(e) of the Bankruptcy Code preempts certain fraudulent transfer avoidance actions brought under state law. While recent case law, most notably in the Second Circuit in the *In re Tribune Co.* multi-district fraudulent transfer LBO litigation, has found that state law constructive fraudulent transfer claims involving these kinds of transactions are prohibited under section 546(e)'s safe harbor, the court in Delaware held that the rationale for the safe harbor and the doctrine of preemption were not implicated under the facts before it and allowed the state law claims to proceed.

Background

In the *Physiotherapy* case, the trustee of a liquidating trust 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.

The trustee's complaint alleged fraud against the debtor's controlling shareholders in overstating the company's revenues and value in the debt financing for the LBO transaction. The proceeds of the debt financing were paid out to the company's owner and the trustee alleged that the company received no value in return. Therefore, according to the complaint, the transaction allegedly worked a constructive fraud upon the company's creditors by adding significant secured debt that could not be paid while rewarding the company's former shareholders who helped orchestrate the deal.

Bankruptcy avoidance powers

Generally, under either section 548(a)(1)(B) (the Bankruptcy Code's fraudulent transfer avoidance provisions) or section 544(b)(1) of the Bankruptcy Code (the power to pursue claims under state law fraudulent transfer statutes), a trustee can seek to avoid and recover fraudulent transfers. In *Physiotherapy*, it was the trustee's avoidance power under section 544(b)(1) to assert state law constructive fraudulent transfer claims that was at issue.

Section 546(e) safe harbor provisions

Recently, in cases involving LBOs like the one before the court in *Physiotherapy*, constructive fraud claims have been blocked by the so-called "safe harbor" provisions of the Bankruptcy Code found in section 546(e). 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 and is often relied upon as a defense to fraudulent transfer actions by shareholders who receive buy-out "settlement" payments in LBO transactions. The policy underlying the section 546(e) safe harbor was a desire to prevent litigation involving securities transactions that might have a destabilizing "ripple effect" on the financial markets.

The opinion

The scope of the section 546(e) safe harbor was addressed most recently by the U.S. Court of Appeals for the Second Circuit in *In re Tribune Co. Fraudulent Conveyance Litigation*, which affirmed the district court's dismissal pursuant to section 546(e) of state law constructive fraudulent transfer claims against a debtor's former shareholders who were paid from the funds in an LBO transaction. The Second Circuit held that, because the safe harbor provision prohibited avoidance proceedings involving transfers by or to financial intermediaries effectuating settlement payments in securities transactions, section 546(e) preempted state fraudulent transfer law.[2]

In *Physiotherapy*, the defendant shareholders sought similar shelter under the section 546(e) safe harbor protections. The trustee argued 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 section 546(e) preempts fraudulent transfer state law with respect to the trustee's claims.

Declining to follow the Second Circuit, the court in *Physiotherapy* turned rather to the Second Circuit's 2014 *Lyondell* decision that was predicated on 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." The *Lyondell* court held that, because "the States have traditionally occupied the field of fraudulent transfer law, applying the presumption against preemption is therefore appropriate." [3]

As in *Lyondell*, the *Physiotherapy* court found section 546(e)'s safe harbors were not intended to shield "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." [4]

The *Physiotherapy* court similarly found that permitting the trustee to pursue the state law fraudulent transfer claims that involved one-off transactions with non-publicly traded securities would not implicate the concerns that the safe harbor provisions are meant to protect against the destabilizing "ripple effect" on the financial markets. The court also took note of the alleged bad faith of the shareholders, whose control of the debtor was alleged to have caused the complained of conduct of the LBO transaction.

In making its decision, the court held 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."

Impact of the decision

It remains to be determined what the broader effect of the court's decision will be. The court's decision can be read to be limited to cases where the securities at interest are not publicly traded and there is some allegation of shareholder impropriety. The parties to the litigation have agreed to extend the defendants' deadline to appeal the matter to the Third Circuit, an appeal that appears certain to be taken. Additionally, within days of the *Physiotherapy* decision, the Bankruptcy Court in the Southern District of New York denied a motion to dismiss filed on behalf of certain term lenders in an adversary proceeding pending in the *General Motors* reorganization.[5] Among the issues addressed in the court's denial was the scope of the safe harbor under section 546(e). The court in the *GM* case could have denied the motion with respect to the section 546(e) issue without even reaching the merits of the defendants' argument but chose instead to expound at some length on the legal issues raised under 546(e). Ultimately the court concluded that the interest payments at issue, which did not retire the underlying debt, were not "settlement payments" in the context of a purchase, sale or redemption to complete a transaction and therefore fell beyond the protection of the safe harbor. The *GM* court left for a later date a determination as to whether the interest payments may fall within the ambit of payments on a "securities contract" entitled to section 546(e)'s protection from claw back.

Regardless of the ultimate impact of the *Physiotherapy* decision beyond the specific facts in that case, these recent decisions make clear that courts are looking closely at the application of section 546(e) in a variety of circumstances, suggesting that recipients of payments on securities and debt instruments have to carefully consider how broadly a court will apply the section 546(e) safe harbor to protect these payments from avoidance and recovery by a bankruptcy trustee. Moreover the appeal of the *Physiotherapy* decision sets the stage for a possible split of authority at the circuit courts that might inspire further review of the safe harbor provisions of section 546(e).

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[1] *In re Physiotherapy Holdings Inc.*, No. 15-51238 (Bankr. D. Del. June 20, 2016).
[2] *In re Tribune Co. Fraudulent Conveyance Litigation*, No. 13-3992-cv (L) (2nd Cir., March 24, 2016).
[3] *In re Lyondell Chem. Co.,* 503 B.R. 348, 372-73 (Bankr. S.D.N.Y. 2014).
[4] *In re Physiotherapy Holdings Inc., No. 15-51238 (*Bankr. *D. Del. June 20, 2016)*.
[5] *Motors Liquidation Company Avoidance Trust v. JP Morgan Chase Bank, N.A, et al.*, Adv. Pro. No. 09-00504 (MG) (Bankr. SDNY, June 30, 2016).