# Educational Materials

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## Can the Trustee Bring that Lawsuit? Exploring Standing and *In Pari Delicto* Issues in Chapter 11 Cases

Roundtables Presented By

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**Federal Pre-emption and 11 U.S.C. §546(e)**
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An increasing number of courts have dismissed the avoidance actions of trustees and creditors' committees, particularly in *Ponzi* schemes and other fraud cases, because the defendant has shoe horned its way into the safe harbor defense known as 11 U.S.C. §546(e). In response, the creditors have sought a "work around" to the defense by bringing actions based upon their own standing under state fraudulent transfer laws or the equitable doctrine of "unjust enrichment". The defendants have retaliated by asserting that such claims are barred by the doctrine of "federal pre-emption". This paper shall first examine the historic doctrine of federal pre-emption and then examine recent case law involving attempts by trustees, creditors' committees and creditors to effect a successful work around of §546(e).

## Federal Pre-emption

We live in a federation with dual sovereignty by both the federal and state governments. On occasion the laws of the federal government will conflict with the laws of the state government. Article VI clause 2 of the U.S. Constitution resolves that conflict in favor of the federal government. When that happens, the federal laws pre-empt the state laws.

The doctrine of Federal Pre-emption falls into three applications : express pre-emption, field pre-emption and conflict pre-emption. The latter category has two sub-categories: impossibility and obstruction.

## Express Preemption

The first type of pre-emption is "express pre-emption". Express pre-emption occurs when Congress specifically states that its enactment shall supersede any contrary state enactments *Arizona v. United States*, ___U.S. ___; 132 S. Ct. 2395 (2012). In insolvency

legislation, Congress, in enacting the Religious Freedoms Restoration Act, clearly pre-empted contrary non-bankruptcy federal and state laws.

**Field Pre-emption**

Field Pre-emption occurs when Congress has manifested an intent to occupy the field in a discrete area. This usually occurs where there is a comprehensive scheme of federal regulation that leaves little doubt that Congress did not intend the states to participate in any form whatsoever; *English v. Gen. Elec. Co*. 496 U.S. 72 (1990).

**Conflict Preemption**

The most complex area of pre-emption is conflict pre-emption. The first type of conflict pre-emption occurs when the state law actually conflicts with federal law, including situations in which it is impossible for a private party to comply with both state and federal requirements. This is a narrow defense and seldom successful.

On the other hand, the obstacle pre-emption doctrine applies when the state law creates an obstacle to or a penalty for compliance with federal law. The state law must be at odds with the purposes or objectives of a Congressional enactment or federal regulation. For conflict preemption to apply, the conflict must be stark and the repugnance or conflict is so direct and positive that the two acts cannot be reconciled or consistently stand. *In re Methyl Tertiary Butyl Ether Prods. Liab. Litig. 7*25 F.3d 65 (2nd Cir. 2013).

**Recent Case Law on Preemption**

These types of preemption cases arise in three scenarios: a) the trustee, debtor in possession or creditors' committee is the plaintiff; b) the trustee or debtor in possession has thrown in their lots with the estate's creditors in a post-confirmation litigation trust and c) the creditors bring stand alone suits a in a non-bankruptcy court.

*In re Hechinger Investments Company of Delaware* 274 B.R. 71 (D. Del 2002), a creditors' committee brought fraudulent transfer, unjust enrichment claims and breach of fiduciary duty claims. The district court made quick work of the fraudulent transfer claims finding that the safe harbor defense protected the plaintiffs under 11 U.S.C. 546(e). The court found that the Committee's unjust enrichment claims had to be dismissed because of both field pre-emption and conflict pre-emption, although the court found that conflict pre-emption was the greater problem. The court was troubled that the unjust enrichment claim sought the same remedy as the fraudulent transfer claim, a monetary judgment in the same amount of money. As such, brining an unjust enrichment claim would frustrate Congress' intent of protecting certain transactions from avoidance under §546(e).

*Contemporary Industries Corporation et al v. Frost et al* 564 F.3d 981 (8th Cir. 2009), involved an action brought by the debtor in possession and the creditors' committee to avoid a fraudulent transfer in a leverage buy out transaction or in the alternative for unjust enrichment. The court first sustained the U.S. District Court's decision that §546 protected the defendants and then considered the unjust enrichment theory. The Court followed *Hechinger* and found that the unjust enrichment would completely eviscerate the safe harbor defense and be contrary to the intent of Congress.

In *Greede v. FCStone LLC,* 746 F.3d 244 (7th Cir. 2014), the court followed *Frost* and held that 546(e) was an absolute defense and that unjust enrichment was preempted. The interesting twist in Greede was that the plaintiff was a litigation trust formed post-petition and the unjust enrichment claims were being asserted by the Trustee on behalf of the individual creditors, not the estate.

Against this back drop, comes three very recent cases from the Southern District of New York. The first case is *Whyte as trustee of the SemGroup Litigation Trust v. Barclays, NA.,* 494 B.R.196 (S.D. N.Y. 2013). This case involved a suit by a post confirmation litigation trustee. In the *res* of her trust were the estate's claims and the non-derivative/direct claims of creditors. The two year statute of limitations under 546(a) had expired and the defendants asserted a safe harbor defense under §5436(e). The trustee was prosecuting state law fraudulent transfer claims, which she claimed remained the property of the creditors, in spite of the confirmation of the debtor's plan. The U.S. District Court, District Judge Jed Rakoff held that conflict pre-emption blocked the trustee's end around run. In reaching this decision Judge Rakoff followed both the *Frost* and the *Hechinger* cases. Judge Rakoff observed that since the debtor had controlled 20% of the country's crude oil inventory made the exclusive application of §546(g) even more important. This case is now on appeal to the Court of Appeals for the 2nd Circuit.

A few months later, another District Judge in the Southern District of New York, Richard Sullivan, reached an entirely different conclusion in *In re Tribune Company,* 499 B.R. 310 (S.D. N.Y. 2013). In that case individual creditors received permission from the Bankruptcy Court in Delaware to bring constructive fraudulent transfer claims against certain targets. The estate retained the actual intent fraudulent transfer claims. The defendants moved to dismiss the claims on several grounds, one of which was federal preemption.

The court started its analysis with the statute itself. §546(e) only prohibits the Trustee (including Debtor in Possession and Creditors Committees) from bringing such suits. Congress says in a statute what it means and means in a stature what it says there. *Hartford Underwriters Inc. Co. v. Union Planters Bank,* N.A 530 U.S. 1 (2000). Thus, the court eliminated express preemption.

Next, the court looked at conflict preemption and obstacle preemption in particular. The Court found that the burden of establishing obstacle preemption is heavy. The Court again noted that Congress, despite numerous amendments, has declined to expand §546(e) beyond trustees. The defendants urged the court to consider the policy reasons for 546(e) and not limit itself to the language of the statue. What is ironic, is that if the court interpreted §546(e) based upon what Congress had intended, it probably would not have applied it in the first place, since Congress was interested in protecting only publicly traded securities. The court found that there are other polices in the bankruptcy code, including making creditors whole, which would be impaired by sustaining the defendant's objections. Next, the court noted that there other provisions of the code where Congress did expressly preempt state law – 11 U.S.C. §§541(c)(1) and 1123(a). Congress knew how to express an intent when it wanted to do so.

Finally, the court distinguished the *Whyte* case by pointing out that the creditor plaintiffs at bar were not creatures of a post confirmation plan. However, the court sent out a warning that the Trustee may not simply relinquish constructive fraudulent conveyance claims while retaining intentional claims, so there is some limit to the collusion between trustee and creditors.

However, the plaintiff's victory on pre-emption was a pyrrhic one, because the court dismissed the case on the grounds that the estate had retained the actual intent cases; and, thus, the creditors lacked standing and were subject to the automatic stay.

This decision, too, is now subject to appeal before the Court of Appeals for the 2nd Circuit.

Finally, there is the extremely well written opinion in *Lydondell Chemical Company*, 503 B.R. 348 (Bankr. S.D. N.Y. 2014). This case involved actions by a creditors litigation trust for constructive fraudulent transfers to recover $12.5 billon that shareholders received in a leveraged

by out. The trust at bar and two others were created pursuant to a confirmed plan of reorganization. The plan provided that all claims owned by the estate pursuant to 11 U.S.C. §544 were deemed abandoned. The *res* of the trust was the creditors' personal interest in avoidance actions. The court commenced its analysis by noting its agreement with both the *Tribune* case and an unreported decision *Development Specialists, Inc. v Kaplan (In re Irving Tanning Co)* No. 12-01024 (Bankr. D. Me 2013).

First, the court dismissed the defendants' contention that there was any expressed preemption based upon the language of the statute and its restriction to trustees. The court further noted that the creditor trust claims were not even brought pursuant to either 11 U.S.C. §§544 or 548.

Likewise, the Court dismissed field preemption as well. The Court noted that over 200 years of history reveal that Congress has permitted state and federal fraudulent transfer laws to work together side by side. States have regulated fraudulent transfer far longer than the federal government has.

Finally, the court looked at conflict preemption's obstacle branch. The court followed the *Tribune* decision in noting that Congress had numerous objectives including making creditors whole, equality of distribution and the absolute priority rule. The court also noted that Congress did not extend §546(e)'s protection to either pre-petition fraudulent transfer actions under state law or to avoidance actions under 11 U.S.C. §548(a)(1). The court also noted that in the 1990's Congress enacted the Liberty and Charitable Donation Protection Act of 1998 Pub. L. No. 104-183 June 19, 1998, 112 Stat. 517. In this enactment, Congress specifically protected religious donations not only from avoidance in the bankruptcy system, but also under 28 U.S.C. §3301 et. seq. and state law. Congress knew how to preempt statute law when it

wanted to do so. Thus, the statutory construction cannon of *inclusion unis est exclusion alterious* should apply. The case for federal pre-emption is particularly weak where Congress has indicated its awareness of the operation of state law in a field of federal interest, and has nonetheless decided to stand by both concepts. *Wyeth v. Levine* 555 U.S. 555 (2009).

## Summary

Reading the cases it is clear that Trustees, debtors in possession and creditors' committee cannot use the doctrine of unjust enrichment as a work around in their cases. Further, courts seem hostile to creditor trusts in which the estate's claims are comingled with the creditors' claims. The *Tribune* court cautions the reader about collusion. However, where creditors are bringing their fraudulent transfer claims against a target and those claims have been completely abandoned by the trustee, the *Tribune, Lyondell* and *Tanner* cases suggest strongly that the doctrine of preemption, particularly obstacle preemption should not apply. However, the law is unsettled and the *Tribune* and *Whyte* case are on appeal. That appeal will probably not be resolved until 2015. Until that time, we live in interesting times according to a certain bankruptcy curse.