LAWSUIT AGAINST LYONDELL SHAREHOLDERS FOR REPAYMENT OF LBO PROCEEDS SURVIVES MOTION TO DISMISS

Timothy J. Durken is a bankruptcy & restructuring, finance, litigation and transactions attorney at Jager Smith P.C. and may be reached at tdurken@jagersmith.com [1]

The author examines the SDNY Bankruptcy Court's *Lyondell* decision holding that Section 546(e)'s safe harbor for settlement payments of securities transactions does not apply to or preempt a state law constructive fraudulent transfer action seeking to recover LBO payments to shareholders.

The SDNY Bankruptcy Court ruled in January 2014 that the post-confirmation Creditor Trust's lawsuit against Lyondell shareholders seeking repayment of LBO proceeds as intentional and constructive fraudulent transfers under state law can continue to go forward.[2]

In 2007, Lyondell was acquired in an LBO led by Leonard Blavatnik for $21 billion of debt secured by the company's own assets. Shareholders were paid $12.5 billion of the LBO proceeds. Less than 13 months later, Lyondell filed for bankruptcy under the weight of the LBO debt. The Creditor Trust argues that the LBO payments allowed shareholders to leap frog unsecured creditors in violation of the absolute priority rule of bankruptcy law that debt is paid before equity. The clawback action sought to recover $6.3 billion from shareholders to pay creditors.

Generally, the Creditor Trust must allege and prove that the payments to shareholders were made with actual intent to hinder, delay, or defraud creditors (an intentional fraudulent transfer) or made for less than reasonably equivalent value and caused Lyondell to become insolvent, have unreasonably small capital, or be unable to pay its debts (a constructive fraudulent transfer). Shareholders filed a motion to dismiss on five grounds, which was granted in part and denied in part by the Court.

First, shareholders sought to rely on Section 546(e) of the Bankruptcy Code that provides a safe harbor prohibiting a bankruptcy trustee from avoiding under Sections 544 and 548 of the Bankruptcy Code (except an intentional fraudulent transfer claim under Section 548(a)(1)(A)) certain settlement payments made in securities transactions. But the Creditor Trust was intentionally structured to avoid the Section 546(e) proscription and did not assert claims under Section 544 or 548. Instead, the state law fraudulent transfer actions, which could have been brought by a bankruptcy trustee under Section 544, were abandoned by the Debtors and contributed by the individual creditors to the Creditor Trust to be brought on their behalf.

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Judge Gerber followed the recent decision in *Tribune*[3] and held that Section 546(e) is not applicable to the state law actions and further that the claims are not preempted by federal bankruptcy law. There was no contention that Congress expressly preempted the state law actions. The Court also could not find field preemption where federal and state fraudulent transfer statutes have coexisted for centuries and Section 544 expressly incorporates state law avoidance actions. Finally, the Court rejected shareholders' conflict preemption argument on both impossibility and obstacle grounds.

With respect to obstacle conflict preemption, the Court followed the well-reasoned *Tribune* opinion and held that state fraudulent transfer laws do not stand as an obstacle to or actually conflict with the full purposes and objectives of Congress. Judge Gerber recognized that Section 546(e)'s protection of the financial markets from reversal of settled securities transactions was merely one of many competing concerns in bankruptcy policy. Those concerns include the availability of avoidance actions to recover a debtor's transfers for the ratable and equitable distribution to similarly situated creditors and the absolute priority rule providing that creditors are paid before shareholders. Further, Congress was well aware of how to expressly preempt state fraudulent transfer laws and did so with respect to charitable contributions. Because Congress was fully aware of state fraudulent transfer laws and chose not to expressly preempt them with respect to Section 546(e), Judge Gerber could not find conflict preemption.

Even if the policies underlying Section 546(e) were the only federal policies to be implemented (which is not the case), Judge Gerber explained that he still would not have found conflict preemption. Section 546(e) is concerned with protecting financial markets from a "ripple effect" caused by the insolvency of one securities firm spreading to other firms like falling dominos and threatening a systematic collapse of the market. Section 546(e) was not added to the Bankruptcy Code with a concern to protect individual investors. Drawing a line between the needs of the markets and creditors, the Court held that there is simply no systematic market risk in the reversal of LBO payments to shareholders (including financial institutions) at the end of the asset transfer chain. Judge Gerber followed *Tribune* in distinguishing the *Whyte*[4] case arising out of the SemGroup bankruptcy, which involved a single trust bringing both bankruptcy trustee and individual creditor state law fraudulent transfer claims, and "more fundamentally" disagreed with the analysis in *Whyte* as flawed.

Second, Judge Gerber rejected as "puzzling" the shareholders' argument that the LBO payments were never Lyondell's property because the payments merely passed through Lyondell from the banks to shareholders. As routinely done, the Court collapsed the transactions of the LBO—(1) the pledge of a security interest in all of Lyondell's pre-existing property as collateral, and (2) the payment of loan proceeds secured by such collateral to shareholders—to find that the LBO payments constituted property of Lyondell subject to avoidance.

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Third, the Court granted the motion to dismiss as to all Defendants that were mere conduits (including nominees or depositories) of LBO proceeds. An "initial transferee" from which avoidable transfers may be recovered does not include those who are not beneficial owners of the LBO proceeds.

Fourth, the Court held that the Creditor Trust could not avoid fraudulent transfers on behalf of and for the benefit of the LBO lenders who were participants and must be deemed to have ratified the transfers as part of the LBO. This is critically important to shareholders because the Creditor Trust will now only be able to recover up to the amount owed to trade creditors and bondholders harmed by and who did not participate in the LBO.

Fifth, with respect to the intentional fraudulent transfers, the Court found that the Creditor Trust failed to allege that CEO Dan Smith controlled Lyondell with respect to the LBO and shareholder payments, whether by influence on remaining Board members or otherwise, to impute his fraudulent intent to Lyondell. Further, the Creditor Trust failed to identify the particular Debtors that made the fraudulent transfers (although corporate distinctions ultimately could be disregarded under the collapsing doctrine). The Court dismissed the intentional fraudulent transfer claims as deficient, but with leave for the Creditor Trust to replead the claims to correct the deficiencies. The Court found sufficient allegations of fraudulent motive with respect to CEO Smith and other corporate officers and directors seeking to enrich themselves through benefits secured in the LBO, including as shareholders of Lyondell, with reckless disregard of the harmful consequences to creditors. Similarly, the Court rejected shareholders' argument that the allegations are not plausible because of participation in the LBO by the sophisticated LBO lenders. Judge Gerber recognized that the LBO lenders were motivated to participate in the LBO to earn substantial fees and the fact that their secured interest ensured payment ahead of unsecured creditors.

The *Lyondell* decision is another important step with *Tribune* of repositioning the rights of creditors in front of shareholders in failed LBOs and recognizing that avoiding LBO payments to shareholders at the end of the transfer chain does not implicate the market protection concerns of Section 546(e). The *Tribune* and *Whyte* decisions have been appealed and are being heard in tandem by the Second Circuit early this year.[5] The Lyondell Creditor Trust has filed an appearance as amicus counsel in that action[6] and an appeal of the *Lyondell* decision is expected. These appeals should be closely watched for their effect on the ability of creditors to recover from shareholders of failed LBOs.

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[1] The author worked on LBO and other litigation issues for the Lyondell post-confirmation trusts at his previous firm and on behalf of the post-confirmation litigation trust challenging the failed LBO transaction in the Boston Generating, LLC bankruptcy cases in the Southern District of New York, Case No. 10-14419.

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[2] *See* Decision and Order on Motion to Dismiss, *Weisfelner v. Fund 1 (In re Lyondell Chemical Co.),* No. 09-10023, Adv. No. 10-4609 (Bankr. S.D.N.Y. Jan. 14, 2014) (Gerber, B.J.).
[3] *In re Tribune Co. Fraudulent Conveyance Litig.*, 499 B.R. 310 (S.D.N.Y. 2013) (Sullivan, J.).
[4] *Whyte v. Barclays Bank PLC*, 494 B.R. 196 (S.D.N.Y. 2013 (Rakoff, J.).
[5] *Whyte v. Barclays Bank PLC*, Case No. 13-2653 (2d. Cir.), ECF Nos. 192-93, 198; *In re Tribune Co. Fraudulent Conveyance Litig.*, Case No. 13-3992 (2d Cir.), ECF Nos. 33-34, 37.
[6] *In re Tribune Co. Fraudulent Conveyance Litig.*, Case No. 13-3992 (2d Cir.), ECF Nos. 130-32.

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