Post-*Merit* Decision Finds that Section 546(e) Safe Harbor Protection for Leveraged Buyouts is Alive and Well

On February 27, 2018, the Supreme Court unanimously affirmed the Seventh Circuit's decision in *Merit Management Group, LP v. FTI Consulting, Inc.* that section 546(e) of the Bankruptcy Code does not protect "transfers that are simply conducted through financial institutions … where the [financial institution] is neither the debtor nor the transferee but only the conduit."[1] The *Merit* decision reversed settled law in the Second, Third, Sixth, Eighth, and Tenth Circuits holding that section 546(e) bars a bankruptcy trustee from pursuing constructive fraudulent transfer claims challenging transfers involving a financial institution or other entity named in the statute, regardless of whether the financial institution or other enumerated entity acted only as a conduit.[2] The *Merit* decision thus seemingly revived a bankruptcy estate's ability to pursue constructive fraudulent transfer claims arising out of a leveraged buyout or similar securities transaction gone wrong in those circuits. The Supreme Court left open the possibility that section 546(e) might still preclude such claims, however, noting that the parties in *Merit* had not contended "that either the debtor or petitioner … qualified as a 'financial institution' by virtue of its status as a 'customer' under § 101(22)(A)" of the Bankruptcy Code, and that the Court "therefore d[id] not address what impact, if any, § 101(22)(A) would have in the application of the § 546(e) safe harbor."[3]

That question was addressed for the first time last week, when Judge Denise Cote of the Southern District of New York denied a request by the trustee for the Tribune Litigation Trust (the "Litigation Trustee") for leave to amend his complaint to add constructive fraudulent transfer claims seeking to avoid and recover the payments Tribune made to its former shareholders in connection with its 2007 leveraged buyout (the "LBO"). *In re Tribune Co. Fraudulent Conveyance Litig.*, No. 11MD2296 (DLC), 2019 WL 1771786 (S.D.N.Y. Apr. 23, 2019). The *Tribune* court ruled that the Litigation Trustee was barred from pursuing such claims notwithstanding *Merit*, because Tribune was itself a "financial institution" that qualified for protection under section 546(e). The *Tribune* decision may have wide-ranging implications, and suggests that the perceived revitalization of constructive fraudulent transfer claims occasioned by *Merit* may well have been short lived.

I. Background

The *Tribune* case arose out of the LBO, in which Tribune purchased all of its outstanding stock from its public shareholders in two steps for a total of about $8 billion. Tribune filed for bankruptcy less than a year after the second step of the LBO closed, and in 2010, claims arising out of the LBO were asserted on behalf of the Tribune estate by the Litigation Trustee's predecessor, the Official Committee for Unsecured Creditors of Tribune (the "Committee"). At that time, all parties agreed that prevailing law in the Second and Third Circuits (where the action was currently pending and where it was commenced, respectively) barred the bankruptcy estate from pursuing constructive fraudulent transfer claims arising out of the LBO against Tribune's former shareholders, and neither the Committee nor the Litigation Trustee filed any such claims. Following the change

1 138 S. Ct. 883, 887, 200 L. Ed. 2d 183 (2018) (affirming 830 F.3d 690, 691 (7th Cir. 2016) (emphasis in original)).

2 *See In re Quebecor World (USA) Inc.*, 719 F.3d 94, 100 (2d Cir. 2013) (finding safe harbor applicable where covered entity was intermediary); *In re QSI Holdings, Inc.*, 571 F.3d 545, 551 (6th Cir. 2009) (same); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 987 (8th Cir. 2009) (same); *In re Resorts Int'l Inc.*, 181 F.3d 505, 516 (3d Cir. 1999) (same); *In re Kaiser Steel Corp.*, 952 F.2d 1230, 1240 (10th Cir. 1991) (same).

3 138 S. Ct. at 890 n.2.

in law caused by *Merit*, however, Judge Cote granted the Litigation Trustee's request to file a motion seeking leave to amend his complaint to add those claims.

II. Opinion

In opposing the Litigation Trustee's motion to amend, the Tribune shareholders argued, among other things, that the amendment should be denied as futile because Tribune was a "financial institution" that was entitled to the protections of section 546(e) notwithstanding *Merit*.[4] As relevant here, section 546(e) of the Bankruptcy Code precludes a bankruptcy estate from avoiding as a constructive fraudulent transfer "a transfer made by or to (or for the benefit of) a . . . financial institution . . . in connection with a securities contract . . . ." The Bankruptcy Code's definition of "financial institution" at section 101(22)(A) includes, in relevant part, "a Federal reserve bank or an entity that is a commercial or savings bank, industrial savings bank, . . . trust company . . . and, when any such . . . entity is acting as agent or custodian for a customer . . . in connection with a securities contract . . . such customer . . . ."

The Tribune shareholders argued that Tribune was a "financial institution" because it was a "customer" of Computershare Trust Company, N.A. ("CTC"). CTC acted as "Depositary" and "Exchange Agent" at steps one and two of the LBO, respectively, which effectively meant that Tribune transmitted the cash necessary to purchase its shares at each step to CTC, and CTC effectuated the repurchases. There was no dispute that CTC was a financial institution, as the parties agreed that it was both a "bank" and a "trust company."[5] The remaining questions, therefore, were whether (i) Tribune was a "customer" of CTC; (ii) CTC was acting as Tribune's agent; and (iii) CTC was acting "in connection with a securities contract."

The *Tribune* court answered each of these questions in the affirmative. First, the court held that the term "customer" should be interpreted according to its ordinary, dictionary definition, and that Tribune, as a purchaser of CTC's services, fell within that definition. Second, applying a common law definition of agency, the court held that CTC, "which was entrusted with billions of dollars of Tribune cash . . . and was tasked with making payments on Tribune's behalf to Shareholders upon the tender of their stock certificates to CTC," was Tribune's "agent." And third, the court found that CTC was acting in connection with a "securities contract," as that term is defined by sections 741(7)(A)(i), (vii), and (xi) of the Bankruptcy Code, when it repurchased Tribune stock from shareholders as part of the LBO. Accordingly, the court concluded that "[t]he text of Section 101(22)(A) compels the conclusion that Tribune itself was a 'financial institution,'" and that the Litigation Trustee's proposed constructive fraudulent transfer claims were "therefore barred by the safe harbor provided in Section 546(e)."[6] The court stated further that such an outcome "is consistent with Section 546(e)'s goal of promoting stability and finality in the securities markets and protecting investors from claims precisely like" those proposed by the Litigation Trustee.[7]

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4 *Tribune*, 2019 WL 1771786, at *7.

5 *Tribune*, 2019 WL 1771786, at *9.

6 *Id.* at *12.

7 The court also held that the "substantial prejudice" that the proposed amendment would cause to the more than 5,000 shareholder defendants, who had "been in limbo for almost a decade," provided an independent basis on which to deny leave to amend. Given the additional ruling that section 546(e) precluded the amendment, however, it is impossible to know with certainty whether the court would have denied the motion on this ground alone had it reached the opposite conclusion regarding the safe harbor's application.

III. Significance

It is unlikely that the *Tribune* decision will be the last on this issue, as an appeal is likely forthcoming; the Second Circuit is expected to weigh in on the scope of section 546(e) in a related action this year; and the Sixth Circuit recently remanded a case back to the Bankruptcy Court for the Eastern District of Michigan to reconsider the application of section 546(e) in light of *Merit*.[8] If left unaltered and/or endorsed by a court of appeals, however, the *Tribune* decision may well toll the death knell for bankruptcy estate constructive fraudulent transfer claims premised on leveraged buyouts and similar transactions, as a company need only retain a bank or trust company to act as paying agent in order for the transaction to be insulated from such an attack. And the *Tribune* decision may have an even greater impact, as it might be argued that its reasoning should extend to protect any payment made from a debtor's bank account in connection with a securities contract, on the ground that the debtor is arguably the bank's "customer," and the bank is arguably acting as the debtor's "agent." Creditors should thus be mindful of the *Tribune* decision—and the significant impediment to constructive fraudulent transfer claims that it poses—when assessing the value of bankruptcy estate claims that may otherwise provide a source of recoveries.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to reach out to:

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[8] *In re Greektown Holdings, LLC*, No. 18-1167, 2019 WL 1770323 (6th Cir. Apr. 22, 2019).