

# Clients & Friends Memo

## **No, You're a Customer: Recent Second Circuit Decision Circumscribes Merit and Preempts State Law Impairment of Safe Harbor Protections in the Wake of a Failed LBO**

**January 7, 2020**

On December 19, 2019, the United States Court of Appeals for the Second Circuit (the "Second Circuit") affirmed a ruling of the United States District Court for the Southern District of New York (the "District Court") dismissing constructive fraudulent conveyance claims brought by representatives of certain unsecured creditors of Chapter 11 debtor Tribune Company ("Tribune")<sup>1</sup> against Tribune's former shareholders on the ground that the fraudulent conveyance claims were barred by Bankruptcy Code section 546(e)'s safe harbor provision.<sup>2</sup> The Second Circuit held<sup>3</sup> that Tribune itself constituted a "financial institution" for safe harbor purposes because it was a customer of the financial institutions that Tribune utilized as an intermediary and agent in connection with a leveraged buyout transaction ("LBO"). Following the Supreme Court's recent decision in Merit Mgmt. Grp., LP v. FTI Consulting Inc., 138 S. Ct. 883 (2018) (hereinafter "Merit"), which cautioned that a transaction may not be entitled to safe harbor protection simply because a financial institution is utilized as a "mere conduit," the Second Circuit may have charted a course forward for parties looking to stay within the safe harbor.

Additionally, the Second Circuit held that section 546(e)'s safe harbor provision preempts constructive fraudulent conveyance claims brought by a creditor in its own name under applicable state law in addition to constructive fraudulent conveyance claims brought by a bankruptcy trustee under the Bankruptcy Code.

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<sup>1</sup> Cadwalader has represented certain defendants in the Tribune litigation.

<sup>2</sup> Section 546(e) of the Bankruptcy Code provides: "Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title." 11 U.S.C. § 546(e).

<sup>3</sup> The retirees and noteholders have sought a rehearing of the Second Circuit's decision.

## Background and Lower Court Opinion

In 2007, Tribune was acquired in an LBO pursuant to which Tribune borrowed over \$11 billion on a secured basis. That amount, plus the \$315 million equity contribution made by the acquiring investor, was used to refinance some of Tribune's existing debt and cash out its existing shareholders at an above-market value. As part of the LBO, Tribune transferred over \$8 billion to a "securities clearing agency" or other "financial institution" acting as intermediaries in the LBO transaction. Those intermediaries in turn paid the funds to the Tribune shareholders in exchange for their shares, which were returned to Tribune.

On December 8, 2008, following the LBO, Tribune commenced chapter 11 proceedings in the United States Bankruptcy Court for the District of Delaware. An Official Committee of Unsecured Creditors (the "Committee") was appointed to represent the interests of unsecured creditors in Tribune's bankruptcy case. In November 2010, the Committee brought suit against the former Tribune shareholders and other beneficiaries of the LBO alleging that the LBO-related payments constituted intentional fraudulent conveyances. In June 2011, two subsets of Tribune unsecured creditors (retirees and noteholders) brought constructive fraudulent conveyance claims based on the LBO. Following confirmation of a chapter 11 plan in Tribune's bankruptcy case, the Committee's claims were transferred to a litigation trust, while the retirees/noteholders retained control over their claims. The litigation trust's and retirees/noteholders' claims were consolidated into a multi-district litigation proceeding that was transferred to the Southern District of New York.

The Tribune shareholders moved to dismiss the retirees/noteholders' claims. The District Court granted the shareholders' motion on the ground that the Bankruptcy Code's automatic stay deprived retirees/noteholders of statutory standing to pursue their claims so long as the litigation trust was seeking avoidance of the same transfers (albeit based on a theory of actual fraud rather than constructive fraud). The District Court rejected the shareholders' arguments that section 546(e) of the Bankruptcy Code preempted the retirees/noteholders' constructive fraudulent conveyance claims because (i) section 546(e)'s prohibition on avoiding designated transfers applies only to a bankruptcy trustee and (ii) Congress declined to extend section 546(e)'s safe harbor protections to state law fraudulent conveyance claims brought by creditors.

As explained in greater detail below, the Second Circuit ultimately affirmed the District Court's dismissal of the retirees/noteholders' constructive fraudulent conveyance claims, but reversed much of the District Court's reasoning, holding instead that (i) the retirees/noteholders had standing to bring the constructive fraudulent conveyance claims based on multiple orders entered in the Tribune bankruptcy case lifting the automatic stay and (ii) such claims were preempted by Bankruptcy Code section 546(e)'s safe harbor provision.

## The Second Circuit's Decisions

In a prior related decision, the Second Circuit affirmed the District Court's dismissal of the retirees/noteholders' claims on the ground that section 546(e) preempts "fraudulent conveyance actions brought by creditors whose claims are [] subject to Section 546(e)." At the time the first opinion was issued, Second Circuit precedent<sup>4</sup> held that the LBO payments at issue fell within 546(e)'s safe harbor because entities covered by section 546(e) served as intermediaries in the LBO. The retirees/noteholders petitioned the Second Circuit for rehearing en banc, which was denied, and subsequently petitioned the Supreme Court for certiorari. While the certiorari petition was pending, the Supreme Court in Merit rejected Quebecor's interpretation of section 546(e)'s scope, holding instead that section 546(e) does "not protect transfers in which financial institutions served as mere conduits." In light of the Supreme Court's opinion in Merit (and at the express urging of Justices Kennedy and Thomas), the Second Circuit reconsidered its prior decision and issued an amended opinion in the Tribune case.

In its amended opinion, the Second Circuit held<sup>5</sup> that the retirees/noteholders' constructive fraudulent transfer claims were preempted by section 546(e)'s safe harbor provision notwithstanding the Supreme Court's decision in Merit because, while Tribune's use of intermediary financial institutions could no longer support applicability of 546(e) to the LBO transfers, Tribune itself was a financial institution covered by section 546(e)'s safe harbor provision. The Bankruptcy Code defines "financial institution" as "an entity that is a commercial or savings bank, . . . trust company, . . . and, when any such . . . entity is acting as agent or custodian for a customer (whether or not a 'customer', as defined in section 741) in connection with a securities contract (as defined in section 741) **such customer**." 11 U.S.C. § 101(22)(A) (emphasis added).<sup>6</sup>

In analyzing the statute's "such customer" language, the Second Circuit relied on the "core" ordinary definition of the word customer, "someone who buys goods or services," as well as the definition set forth in Black's Law Dictionary, which includes "a person . . . for whom a bank has agreed to collect items." The Second Circuit determined that Tribune retained Computershare, indisputably a financial institution for purposes of the safe harbor, to act as "Depository" in connection with the LBO tender offer and to receive and hold the purchase price for Tribune's

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<sup>4</sup> See In re Quebecor World (USA) Inc., 719 F.3d 94, 100 (2d Cir. 2013) (hereinafter "Quebecor").

<sup>5</sup> The Second Circuit also held that the automatic stay did not bar the retirees/noteholders' constructive fraudulent conveyance claims because the automatic stay was lifted on three separate occasions to permit the filing of the retirees/noteholders' complaint, and the confirmed Tribune plan expressly allowed the retirees/noteholders to pursue their claims.

<sup>6</sup> Cadwalader published a memorandum addressing a prior decision of the District Court in the multi-faceted Tribune fraudulent conveyance litigation addressing these safe harbor issues. That memorandum is available at <https://www.cadwalader.com/resources/clients-friends-memos/the-district-court-in-tribune-circumscribes-merit-and-maintains-section-546e-safe-harbor-protection-for-shareholders-in-the-wake-of-a-failed-lbo>.

shares, retain the shares for Tribune's benefit, and pay the tendering shareholders. Thus, Tribune was Computershare's "customer" and Computershare acted as Tribune's agent in the LBO. Accordingly, Tribune itself constituted a "financial institution" for purposes of determining whether the LBO was protected by section 546(e)'s safe harbor provision.

The Second Circuit further determined that the LBO-related payments were made "in connection with a securities contract"<sup>7</sup> within section 546(e). While the parties agreed that payments made to **purchase** Tribune shares were made in connection with a securities contract, the retirees/noteholders contended that payments made to **redeem** such shares were not. The Second Circuit disagreed because, in the securities context, the term "redemption" means "repurchase." The Bankruptcy Code capaciously defines a "securities contract" to include "a contract for the purchase [or] sale . . . of a security . . . **including any repurchase** . . . transaction on any such security" as well as "any other agreement or transaction that is similar to an agreement or transaction referred to in this subparagraph[.]" 11 U.S.C. § 741(7)(i), (vii) (emphasis added). Accordingly, the Second Circuit held that the LBO transaction was covered by section 546(e)'s safe harbor provision because the constructive fraudulent conveyance claims at issue sought to challenge transfers made by a financial institution in connection with a securities contract.

Finally, the Second Circuit determined that section 546(e)'s safe harbor provision preempts fraudulent conveyance actions brought by creditors under state law in addition to fraudulent conveyance actions brought by bankruptcy trustees under the Bankruptcy Code. The Second Circuit held that "[o]nce a party enters bankruptcy, the Bankruptcy Code constitutes a wholesale preemption of state laws regarding creditors' rights." Additionally, the Second Circuit determined that a fraudulent conveyance claim under section 544 of the Bankruptcy Code still arises under the Bankruptcy Code even though it incorporates applicable state law standards regarding avoiding the transfer in question, and such avoidance claims vested in the bankruptcy trustee upon Tribune's bankruptcy filing. To the extent that individual creditors may bring an avoidance action in their own name, they do so as "a matter of grace under federal authority." Moreover, the policies reflected in section 546(e) relate to securities markets, which are subject to extensive federal regulation and reflect very important federal concerns. Accordingly, the Second Circuit held that section 546(e)'s safe harbor provision preempts state law fraudulent conveyance claims brought by creditors under section 544 of the Bankruptcy Code.

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<sup>7</sup> Note that, because the Second Circuit found that the LBO-related payments were transfers made in connection with a securities contract, the court did not decide whether the payments qualified as "settlement payments" under section 546(e) of the Bankruptcy Code.

## Conclusion

The Second Circuit's decision in Tribune may narrow the impact of the Supreme Court's recent decision in Merit, as any market participant seeking safe harbor protection may consider structuring their transaction to involve a financial institution to facilitate the transaction, thereby potentially bypassing the Supreme Court's warnings regarding using a financial institution as a "mere conduit."

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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