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Safe Harbor Shields Shareholders In Tribune Fraudulent Transfer Litigation

By Michael L. Cook

The U.S. District Court for the Southern District of New York, on April 23, 2019, denied the litigation trustee's motion for leave to file a sixth amended complaint that would have asserted constructive fraudulent transfer claims against 5,000 Tribune Company (Tribune) shareholders. *In re Tribune Co. Fraudulent Conveyance Litigation*, 2019 WL 1771786 (S.D.N.Y. Apr. 23, 2019). The safe harbor of Bankruptcy Code (Code) §546(e) barred the trustee's proposed claims, held the court. *Id.* at 12. Based on undisputed facts, it reasoned that the debtor, Tribune Company (Tribune) "was a 'customer' of CTC" [Computershare Trust Company, N.A.]; CTC was "acting as Tribune's 'agent or custodian' … 'in connection with a securities contract'"; and that both entities were a "financial institution" as defined by the Code. *Id.* at 9. Also, held the court, "at this stage of the litigation," allowing the trustee to amend his complaint "would result in undue prejudice to the [defendant] Shareholders." *Id.* at 12.

This decision means, as a practical matter, that: a) the trustee cannot assert federal constructive fraudulent transfer claims against the shareholders; b) the court has now resolved all of the trustee's other claims in the action; and c) separate individual creditor suits asserting state law constructive fraudulent transfer claims, the subject of the Second Circuit's related decision, 818 F.3d 98 (2d Cir. 2016) (state law claims "preempted by" §546(e)), will also probably be barred. In any event, the court has now effectively dismissed all of the trustee's federal claims against the shareholder defendants.

Relevance

Code §546(e), the so-called "safe harbor" defense, "shields from [a bankruptcy trustee's] avoidance proceedings [*e.g.*, fraudulent transfer, preferential transfers]" based on "transfers by or to financial intermediaries effectuating settlement payments in securities transactions or made in connection with a securities contract, except through an intentional fraudulent [transfer] claim." *In re Tribune Co. Fraudulent Conveyance Litigation*, 818 F.3d 98, 105 (2d Cir. 2016).

Section 546(e) "is a very broadly-worded safe harbor provision that was enacted to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries." *In re Bernard L. Madoff Inv. Sec. LLC*, 773 F.3d 411, 416 (2d Cir. 2014) (citation omitted). "The safe harbor limits this risk by prohibiting the avoidance of 'settlement payments' made by, to, or on behalf of a number of participants in the financial markets." *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329, 334 (2d Cir. 2011) (debtor's early redemption payments to hundreds of commercial paper holders, made through a bank, its securities affiliates and a stockbroker, were "settlement payments" and insulated under §546(e)). Accord, *Peterson v. Somers Dublin Ltd.*, 729 F.3d 741, 748 (7th Cir. 2013); *Grede v. FC Stone, LLC*, 746 F.3d 244, 252 (7th Cir. 2014).

The *Tribune* trustee relied on the Feb. 27, 2018 decision of the U.S. Supreme Court in *Merit Management GRP, LP v. FTI Consulting, Inc.*,

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138 S. Ct. 883, 893 (2018), which held that "the relevant transfer for purposes of §546(e) safe-harbor inquiry is the overarching transfer," rejecting the argument that a bank or trust company acting as a "mere conduit" can be sufficient ground to invoke the safe harbor provision. According to the trustee, "reading the [Code's] definition of "financial institution" to cover an entity like Tribune would [also] run counter to the spirit of the Supreme Court's decision in *Merit Management*. … " 2019 WL 1771786, at 12.

Facts

The trustee's suit against Tribune shareholders arose out of a 2007 leveraged buyout (LBO) of Tribune. As part of the LBO, Tribune purchased its outstanding stock from the defendant shareholders for about $8 billion. It first sent to CTC, which had agreed to act as "Depository," the required cash to repurchase its shares as part of a tender offer. CTC received tendered shares on Tribune's behalf, paying out $34 per share to the tendering shareholders. When the tender offer was oversubscribed, Tribune repurchased more shares, engaging CTC as an "Exchange Agent" to perform essentially the same function as before.

The bankruptcy court confirmed Tribune's reorganization plan in 2012. That plan transferred the federal fraudulent transfer claims here to a litigation trust after several rounds of litigation begun by the trust's predecessor, the Tribune creditors' committee. Those claims, asserted by the trustee, merely alleged intentional (not constructive) fraud, though, apparently because the §546(e) safe harbor does not shield fraudulent transfers made with actual intent.

The district court consolidated about 40 related state law actions against the shareholders across the country. After several rounds of litigation, including separate actions brought with court permission by Tribune's creditors under state fraudulent transfer law, the Second Circuit held that individual creditors' "state law, constructive fraudulent [transfer] claims … are pre-empted by … Code Section 546(e)." 818 F.3d at 105. In response to the creditors' petition for *certiorari*, the Supreme Court deferred its consideration of that petition to "allow the [Second Circuit] or the District Court to consider whether to recall the [Second Circuit's] mandate, entertain a … motion to vacate the earlier judgment, or provide any other available relief in light of [the Supreme Court's] decision in Merit Management." *Deutsche Bank TR. Co. Americas v. Robert R. McCormick Found*, 138 S. Ct. 1162, 1162-63 (2018).

The district court later resolved all outstanding motions in the trustee's litigation and dismissed claims against various remaining defendants. After noting settlements with other defendants, the district court here was left with "only the Trustee's request to amend" his complaint to add federal constructive fraudulent transfer claims under Code §548(a)(1)(B) against former Tribune shareholders. 2019 WL 1771786, at 4.

Analysis

The court rejected the defendants' arguments based on judicial estoppel, bad faith and undue delay by the trustee and the statute of limitations. *Id*. at 5-6. As noted earlier, though, it found that "[s]tanding alone, undue prejudice to the shareholders provides a sufficient basis upon which to deny the Trustee's motion" to add the constructive fraudulent transfer claim. *Id*. at 6. More significant, the court held that the "Trustee's proposed amendment would be futile because his [federal constructive fraudulent transfer claims] are barred by Section 546(e) notwithstanding the Supreme Court's holding in *Merit Management*." *Id*. at 7. The relevant language in §546(e), said the court, "bars a Trustee from asserting a claim for constructive fraudulent [transfer] with respect to a 'settlement payment … made by … [a] financial institution [or] financial participant' or 'a transfer made by … [a] financial institution [or] financial participant … in connection with a securities contract …" *Id*.

The parties agreed that the transfers here were "settlement payments" and in connection with a securities contract and that the transfers were made "by" Tribune. *Id*. at 8. They disagreed, though, as to whether Tribune was an entity covered by Code §546(e), namely, that it was "either a financial institution or a financial participant." *Id*. Because a financial participant had to be "an entity" that "entered into a covered transaction with "the debtor or any other entity," Tribune, the debtor, could not fall within the definition of "financial participant," held the court. *Id*. at 9.

Tribune's Customer Status

But the court found Tribune to be a "customer" of CTC "in connection

with the LBO transactions … here." *Id*. at 10. Although the court did not define the term, the court relied on current dictionary definitions of "customer" as "a buyer or purchaser of goods or services" and "a person having an account with a bank or for whom a bank has agreed to collect items." *Id*. at 9, quoting Black's Law Dictionary (10th ed. 2014).

The court rejected the trustee's reliance on the narrow definitions of "customer" in the Code's sub-chapter that deals with stockbroker and commodity broker liquidations because these limited definitions did not apply here. The "transactions addressed in Section 546(e) are not so limited and the express disclaimer of a limited definition is both appropriate and understandable." *Id*. at 10.

Agent as Financial Institution

CTC was also Tribune's "agent." *Id*. Code §101(22) defines "financial institution" to include an agent. "CTC 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. … [--] a paradigmatic principal-agent relationship." *Id*. at 11.

Securities Contract

Finally, ruled the court, "CTC acted 'in connection with a securities contract.'" *Id*. Because Tribune used CTC to repurchase Tribune stock from Shareholders at both steps of the LBO, that fact confirmed "CTC's involvement in these LBO transactions … 'was in connection with a securities contract'," consistent with §546(e). *Id*.

The court rejected the trustee's argument based on the "independent legal significance doctrine" to call the LBO a "merger." *Id*. According to the court, the LBO was "a securities transaction" and the trustee was "not free to define the transfer it seeks to avoid in any way it chooses." *Id*., *quoting Merit Management*, 138 S.Ct. 1894.

Merit Management Not Dispositive

Most important, the court stressed that the Supreme Court in *Merit Management* had "specifically declined to address the scope of the definition of 'financial institution'," and had declined to "address what impact, if any, §101(22)(A) would have in the application of the §546(e) safe harbor." *Id*. at 12, *quoting Merit Management*, 138 Ct. at 890 n.2. Because the "text of Section 101(22)(A) compels a conclusion that Tribune itself was a 'financial institution,'" it "would be futile" to allow the trustee to assert federal constructive fraudulent transfer claims. *Id*. at 12.

Comment

The court's ruling "is consistent with Section 546(e)'s goal of promoting stability and finality in securities markets and protecting investors from claims precisely like" those sought to be asserted by the trustee here. *Id*. Although the trustee argued that Tribune was not a "systemically important" institution, the court stressed that Tribune had been "a publicly traded, Fortune 500 company" and that the trustee had sued "over 5,000 Shareholders of Tribune." *Id*. The shareholders' "only involvement in this transaction was receiving payment for their shares." *Id*. On these facts, the trustee's attempt "to unwind securities transactions" of this kind "is precisely the sort of risk that Section 546(e)" was intended to minimize." *Id*.

The effect of *Merit Management* is thus limited, for the Supreme Court never addressed the Code's definition of "financial institution." The Second Circuit's 2011 *Enron* decision remains valid because the debtor's cash payments passed through at least two undisputed financial institutions and a stockbroker acting as principals, not conduits; the defendant Alfa was also a "customer" of the stockbroker. But *Merit Management* may have effectively overruled cases like the Second Circuit's 2013 decision in *Quebecor World (U.S.A.) Inc*., 719 F.3d 94, 99 (2d Cir. 2013) (safe harbor applied regardless of whether funds passed through a conduit).

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