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The District Court in *Tribune* Circumscribes *Merit* and Maintains Section 546(e) Safe Harbor Protection for Shareholders in the Wake of a Failed LBO

By Ingrid Bagby, Michele C. Maman, Kathryn M. Borgeson, Eric G. Waxman, and Nicholas B. Vislocky*

In a decision related to the failed leveraged buyout and subsequent bankruptcy of the Tribune Company, the U.S. District Court for the Southern District of New York found that Tribune, the purchaser of stock from its shareholders, employed a bank to effect the two-step leveraged buyout and was a customer of the bank. Consequently, Tribune itself was determined to be a "financial institution" under the broad statutory language of the Bankruptcy Code and the transfers to shareholders were protected from avoidance under Section 546(e). The authors of this article explain the decision and its implications.

Last year, the U.S. Supreme Court issued its decision in *Merit*,[1] unanimously ruling that a buyout transaction between private parties did not qualify for "safe harbor" protection under Bankruptcy Code Section 546(e), on the basis that a "financial institution" acted as an intermediary in the overarching transaction. Section 546(e) protects from avoidance certain transfers by, to, or for the benefit of a financial institution.[2]

The *Merit* ruling is generally portrayed as a narrowing of safe harbor protections by withdrawing non-avoidance protections from transfers to beneficial owners of privately issued securities in a buyout transaction (while affirming protections afforded to securities industry participants, including financial institutions).

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[1] *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, 138 S. Ct. 883, 200 L. Ed. 2d 183 (2018) ("*Merit*").

[2] Section 546(e) provides that "the trustee may not avoid a transfer that is a margin payment, . . . or settlement payment, . . . or that is a transfer made by or to (or for the benefit of) a . . . financial institution . . . in connection with a securities contract . . . ." 11 U.S.C. § 546(e).

However, the question left unaddressed by the Supreme Court in *Merit* was the scope of the term "financial institution."[3]

A district court in the influential Southern District of New York recently answered the question and potentially restored the broad scope of avoidance protections available to parties to certain financial contracts, including securities contracts related to leveraged buyout transactions involving privately issued securities.

In an April 23, 2019, decision[4] related to the failed leveraged buyout ("LBO") and subsequent bankruptcy of the Tribune Company ("Tribune"),[5] Judge Denise Cote found that Tribune, the purchaser of stock (publicly traded securities) from its shareholders, (a) employed a bank (financial institution) to effect the two-step LBO and (b) was a customer of the bank. Consequently, Tribune itself was determined to be a "financial institution" under the broad statutory language of the Bankruptcy Code and the transfers to shareholders were protected from avoidance under Section 546(e).[6]

In the debate about the appropriate scope of safe harbor protections, the *Tribune* Decision may re-direct the discussion to the identity of the parties to a transaction and the tangential involvement of banks and other financial institutions, and away from examining the substance of the transaction and whether it has an impact on the securities markets that Congress intended to protect from disruption by creating the safe harbors in the first instance.

THE *MERIT* DECISION

In *Merit*, Valley View Downs, a private company (race track), acquired a competitor, Bedford, also a private company, by acquiring Bedford's stock from its shareholders, including Merit Management Group, in exchange for cash transfers. The payment was routed through a foreign investment bank and a U.S. commercial bank. It was undisputed that the non-public transaction was

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[3] 138 S. Ct. at 890 n.2 ("The parties here do not contend that either the debtor or petitioner in this case qualified as a 'financial institution' by virtue of its status as a 'customer' under § 101(22)(A) . . . . We therefore do not address what impact, if any, § 101(22)(A) would have in the application of the § 546(e) safe harbor.").

[4] *In re Tribune Co. Fraudulent Conveyance Litig.*, Nos. 11-2296, 12-2652 (DLC) (S.D.N.Y. Apr. 23, 2019) (the "*Tribune* Decision").

[5] Cadwalader has represented certain defendants in the *Tribune* litigation.

[6] *See* 11 U.S.C. § 101(22) (financial institution "means (A) . . . 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 . . . in connection with a securities contract (as defined in section 741) such customer . . . .").

a stock purchase (securities contract) and the payment was either a settlement payment or transfer in connection with a securities contract.

Valley View failed and filed for bankruptcy protection. The bankruptcy trustee subsequently sought to avoid and recover the payment to Merit Management. Neither Valley View nor Merit Management contended that either was a financial institution, but instead focused their arguments on whether the payment could not be avoided because financial institutions acted as intermediaries or conduits in the transaction.

The involvement of a financial institution in the transaction would have been sufficient to invoke Section 546(e) protections in a majority of the circuit courts that had previously addressed the issue.[7] But, in the decision that was appealed to the Supreme Court, the U.S. Court of Appeals for the Seventh Circuit declined to read the safe harbor protections "expansively," focused its analysis on the "economic substance of the transaction," and reversed the dismissal of the trustee's avoidance action.

Justice Sotomayor wrote for the Supreme Court and affirmed the Seventh Circuit. She framed the question as "whether the transfer between Valley View and Merit implicates the safe harbor exception because the transfer was 'made by or to (or for the benefit of) a . . . financial institution.'" To answer the question, "courts [should] look to the transfer that the trustee seeks to avoid . . . to determine whether that transfer meets the safe-harbor criteria . . . ."

In *Merit*, the trustee identified the purchase of the stock by Valley View from Merit Management as the transaction to be avoided. The trustee did not seek to avoid the transactions with the financial intermediaries who were "component parts" and "simply irrelevant to the analysis under sec. 546(e)." Neither Valley View nor Merit is a financial institution or other covered entity. Consequently, "the transfer falls outside the sec. 546(e) safe harbor."

In reaching this conclusion, Justice Sotomayor rebuffed several contentions by Merit that the safe harbors were intended to be broadly applied and that their statutory language reflected this purpose. Safe harbor protections did not reach transactions where transfers were simply made "through" a financial institution. Nonetheless, Justice Sotomayor several times affirmed that financial institutions and other covered entities remained protected under Section 546.

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[7] For example, both the U.S. Courts of Appeals for the Second and Third Circuits precedent states that the Section 546 safe harbor protects settlement payments even if the requisite financial institution was neither the debtor nor the transferee but only a mere conduit. *See In re Quebecor World (USA) Inc.*, 719 F.3d 94, 100 (2d Cir. 2013); *In re Plassein Int'l Corp.*, 590 F.3d 252, 256–57 (3d Cir. 2009).

But the impact of *Merit* was potentially blunted because an important issue was not presented for adjudication or review—what is a financial institution? As noted above, the parties to the appeal did not contend that either Valley View or Merit Management qualified as a financial institution.

Tellingly, at oral argument Justice Breyer asked, "So why are we hearing this case?" He noted that the definition of financial institution included customers and that the banks involved acted as agents or custodians of Valley View. He then concluded, "So why doesn't that cover it?"[8] In the *Tribune* Decision, Judge Cote answered, "It does."

THE *TRIBUNE* DECISION

In 2007, in a two-step LBO, Tribune purchased all of its outstanding stock for about $8 billion. Tribune did not repurchase its shares directly from shareholders. Instead, Tribune transmitted the cash to Computershare Trust Company, N.A. ("CTC"), acting as a depositary. CTC, then acting as exchange agent, accepted shares tendered by, and made payment to, shareholders.

Tribune and many of its subsidiaries filed for bankruptcy protection in 2008. Litigation to claw back LBO-related funds paid to shareholders (among others) based on Bankruptcy Code fraudulent transfer provisions was commenced and eventually transferred to a litigation trust. After the *Merit* decision, the litigation trustee renewed a motion for leave to amend the complaint to add claims for constructive fraudulent transfer.

Judge Cote acknowledged that, under Federal Rule of Civil Procedure 15(a), the court should freely give leave to amend when justice requires, but noted that leave may be denied for good reason, including "futility."[9]

Addressing what she characterized as a "straightforward question of statutory interpretation," Judge Cote evaluated the futility of the amendment and, specifically, whether, in light of *Merit*, the Section 546(e) safe harbor barred the constructive fraudulent transfer claims.[10]

Judge Cote prefaced her analysis by reciting circuit court precedent for the proposition that Section 546(e) "was enacted to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries"[11] and to limit risk "by prohibiting the

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[8] Transcript of Oral Argument at 15–16, *Merit*, 138 S. Ct. 883 (No. 16-784).

[9] *Tribune*, *supra* note 4.

[10] *Id.*

[11] *Id.* (citing *In re Bernard L. Madoff Inv. Sec. LLC*, 773 F.3d 411, 416 (2d Cir. 2014)).

avoidance of 'settlement payments' made by, to, or on behalf of a number of participants in the financial markets"[12] so that "honest investors will not be liable if it turns out that a [LBO] or other standard business transaction technically rendered a firm insolvent."[13]

Judge Cote then addressed the question unanswered in *Merit*—was Tribune itself a financial institution? A predicate fact was undisputed—CTC was both a bank and a trust company and, thus a financial institution under the Bankruptcy Code. Judge Cote then posed three questions:

(1) Was Tribune a *customer* of CTC;

(2) Was CTC acting as Tribune's *agent* or *custodian*; and

(3) Was CTC acting *in connection with a securities contract*?[14]

Judge Cote answered all three questions in the affirmative and concluded that Tribune itself qualified as a financial institution under the Bankruptcy Code.[15]

First, relying on lay definitions of *customer*, the district court determined Tribune was a customer of CTC because it purchased services from CTC as a depository in exchange for a fee and, also, because it had an account with CTC—a bank or for whom a bank has agreed to collect items.[16]

Second, Judge Cote acknowledged that CTC, entrusted with holding and making billions of dollars in payments to Tribune's shareholders, was in a "paradigmatic principal-agent relationship" with Tribune.[17] Relying on common-law definitions, the district court recognized that "agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and

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[12] *Id.* (citing *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329, 334 (2d Cir. 2011)).

[13] *Id.* (citing *Peterson v. Somers Dublin Ltd.*, 729 F.3d 741, 748 (7th Cir. 2013)).

[14] *Id.*

[15] The district court also considered, but rejected, the argument that Tribune qualified as a "financial participant" under the Bankruptcy Code, a status that would also have provided Section 546(e) safe harbor protection. *See* 11 U.S.C. § 101(22A) (a financial participant is an entity that has entered into certain financial contracts with the debtor or other entities that meet certain substantiality and timing requirements). After scrutinizing the definition, the District Court found that the debtor could not enter into transactions with itself and concluded that, for purposes of Section 546(e), the definition foreclosed the argument that the debtor could be a financial participant.

[16] *Id.* (citing Merriam-Webster Dictionary Online, https://www.merriam-webster.com/dictionary/customer and Black's Law Dictionary (10th ed. 2014)).

[17] *Id.*

subject to the principal's control, and the agent manifests assent or otherwise consents to so act."[18]

Finally, Judge Cote found it indisputable that CTC's role in the Tribune LBO, namely the repurchase of Tribune's stock from the shareholders, was in connection with a securities contract.[19]

In sum, through its status as a customer of CTC (a financial institution acting as agent for Tribune in connection with a securities contract), Tribune itself qualified as a financial institution for purposes of invoking the protections of the Section 546(e) safe harbor. Consequently, Tribune's LBO-related payments to its shareholders were not subject to avoidance as a matter of law and the Trustee's motion for leave to file an amended complaint was denied as futile.[20]

TAKEAWAYS FROM THE *TRIBUNE* DECISION

Congress enacted the safe harbor provisions of the Bankruptcy Code to promote market stability and to mitigate the risk that the insolvency of one counterparty could spread to other firms, threatening the financial industry. Section 546(e) insulates the securities transfer system from constructively fraudulent conveyances and preference actions, with the goal of minimizing market volatility by ensuring the prompt and final resolution of securities transactions.[21] But courts have interpreted Section 546(e) and the transfers it protects (*e.g.*, settlement payments) to include a wide range of transactions, such as transfers to beneficial owners of privately issued securities in leveraged buyouts with debatable impact on the securities transfer system.[22]

Indeed, a recent American Bankruptcy Institute report questioned the use of

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[18] *Id.* (citing Restatement (Third) of Agency § 1.01 (2006)).

[19] The district court acknowledged that "the term 'securities contract' expansively includes contracts for the purchase or sale of securities, as well as any agreements that are similar or related to contracts for the purchase or sale of securities." *Tribune*, *supra* note 4 (citing *In re Madoff*, 773 F.3d at 418, and 11 U.S.C. § 741(7)(A)(i) ("securities contract" includes "a contract for the purchase, sale, or loan of a security . . . including any *repurchase* . . . transaction of any such security") (emphasis added)).

[20] *Id.*

[21] *See* H.R. Rep. No. 97-420, at 1–2 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583–84 ("[C]ertain protections are necessary to prevent the insolvency of one commodity or securities firm from spreading to other firms and [possibly] threatening the collapse of the affected market.").

[22] *See QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.)*, 571 F.3d 545 (2009) 571 F.3d 545 (6th Cir. 2009) (abrogated by *Merit* decision); *Contemporary Industries Corporation v. Frost*,

the Section 546(e) safe harbor to protect the ultimate beneficiaries of LBOs involving privately issued securities and recommended removal of safe harbor avoidance protections in those circumstances.[23]

In *Merit*, the Supreme Court framed the inquiry to analyze the substantive transaction ("the transfer that the trustee is seeking to avoid") and the parties to that transaction, and withdrew safe harbor protection from recipients of transfers in a buyout transaction that involved privately issued securities (while affirming protection for financial institutions involved in the transaction). This outcome was perceived by several commentators as narrowing safe harbor protections and as consistent with congressional intent.

The *Tribune* Decision is arguably consistent with the *Merit* outcome and congressional intent, since it involved transfers of publicly issued securities. But, to reach her conclusion, Judge Cote answered the question left open in *Merit*—the scope of the term "financial institution"—and may have limited *Merit* as a consequence. What buyout transaction seeking safe harbor protection does not involve customers of financial institutions or could readily be structured to do so?

Whether guidance on this question may be forthcoming from court rulings interpreting the broadly worded safe harbor provisions or requires legislative change remains to be seen. In the interim, an appeal of the *Tribune* Decision to the U.S. Court of Appeals for the Second Circuit has been filed,[24] a tribunal that, prior to the *Merit* decision, had broadly interpreted the Section 546(e) safe harbor provisions.[25]

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564 F.3d 981 (8th Cir. 2009); *Brandt v. B.A. Capital Co. (In re Plassein Int'l Corp.)*, 590 F.3d 252 (3d Cir. 2009).

[23] American Bankruptcy Institute Commission to Study the Reform of Chapter 11, Final Report and Recommendations, pp. 94–98 (2014).

[24] On July 15, 2019, Marc. S. Kirschner, as Litigation Trustee for the Tribune Litigation Trust and Plaintiff in *Tribune*, filed a Notice of Appeal to the U.S. Court of Appeals for the Second Circuit. *See Kirschner v. Fitzsimons, et al.*, Nos. 11–2296, 12–2652 (DLC) (S.D.N.Y. Jul. 15, 2019), Docket No. 6343.

[25] *See supra* note 7.