GIBSON DUNN

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SECOND CIRCUIT ISSUES IMPORTANT RULING REGARDING BANKRUPTCY CODE "SAFE HARBOR" POST-MERIT MANAGEMENT

To Our Clients and Friends:

On December 19, 2019, in *In re Tribune Company Fraudulent Conveyance Litigation*, 2019 WL 6971499 (2d Cir. Dec. 19, 2019),[1] the Second Circuit held that the "safe harbor" provision in section 546(e) of the Bankruptcy Code barred claims seeking to claw back payments that Tribune Company ("Tribune") made to public shareholders in 2007 as part of a go-private transaction. That section bars the avoidance of certain types of securities and commodities transactions that are made by, to or for the benefit of certain protected entities (each a "Covered Entity"), including a "financial institution."[2] The Second Circuit held that Tribune constituted a financial institution pursuant to the Bankruptcy Code definition of "financial institution," which includes the "customer" of a financial institution when the financial institution acts as the customer's "agent or custodian … in connection with a securities contract." The Second Circuit also reaffirmed that the safe harbor preempts claims for constructive fraudulent conveyance under state law because the claims are "in conflict with" "[e]very congressional purpose reflected in Section 546(e)."[3]

The decision is significant in the wake of the Supreme Court's February 27, 2018 ruling in *Merit Management Group, LP v. FTI Consulting, Inc*., 138 S.Ct. 883 (2018), which limited the scope of the safe harbor and called into question whether the safe harbor still protects securities transactions such as those in *Tribune*.[4] *Tribune* signals that, at least in the Second Circuit, the safe harbor may still protect securities transactions where a financial institution acts as agent or custodian for the transferor or transferee as its customer.

I. Supreme Court Decision in *Merit Management*

Prior to *Merit Management*, several circuits, including the Second Circuit, held that the safe harbor protected transfers that passed *through* a financial institution or other Covered Entity acting as a conduit, even if neither the transferor nor the transferee was itself a Covered Entity. *Merit Management* rejected that theory and held that the safe harbor protects a transaction only if the transferor or the transferee of the "relevant transfer" (i.e., the "overarching" transfer sought to be avoided) was itself a Covered Entity.[5] *Merit Management* thus limited the scope of the safe harbor.

Merit Management expressly declined to address whether, because the Bankruptcy Code defines a "financial institution" to include the "customer" of a "financial institution" under certain circumstances,[6] the safe harbor protects a transfer made by or to a party that constitutes a protected "customer" but is not otherwise a Covered Entity.[7] That was the issue decided in *Tribune*.

II. Background in *Tribune*

In 2007, Tribune, a public company, consummated a tender offer and then went private through a merger six months later. In the tender offer, Tribune borrowed funds and transmitted the cash required to repurchase approximately 50% of its outstanding shares to Computershare Trust Company, N.A. ("CTC"), which acted as "Depositary." CTC, on Tribune's behalf, then accepted and held tendered shares and paid out $34 per share to tendering shareholders. In the merger, CTC acted as an "Exchange Agent" and performed essentially the same function.

One year after the merger, on December 8, 2008, Tribune and various subsidiaries commenced chapter 11 bankruptcy cases. Former creditors of Tribune obtained relief from the automatic stay in bankruptcy to bring claims seeking to avoid the payments to shareholders as a constructive fraudulent conveyance under state law. The creditors commenced lawsuits in various jurisdictions which were consolidated in a multi-district litigation in the United States District Court for the Southern District of New York.[8] Defendants moved to dismiss the claims on grounds including that they were barred by the safe harbor. The District Court dismissed the claims on different grounds but held that the safe harbor did not bar the claims because the statute expressly bars only claims brought by "the trustee" in bankruptcy, and thus it did not bar claims brought by creditors on their own behalf.[9]

The Second Circuit affirmed the dismissal, holding that the safe harbor preempted (barred) the creditors' claims even though the safe harbor expressly refers only to claims brought by "the trustee."[10] The creditors filed a petition for certiorari in the Supreme Court, which was pending when the Supreme Court decided *Merit Management*. The Supreme Court issued a statement inviting the Second Circuit to reconsider its ruling in *Tribune* in light of *Merit Management*.[11] Because the Second Circuit's prior ruling assumed that the safe harbor applied to Tribune's shareholder payments because the payments passed through Covered Entities (i.e., the theory that *Merit Management* rejected), the Second Circuit recalled the mandate to consider whether "there is an alternative basis for finding that the payments are covered."[12]

III. Second Circuit Holds That Section 546(e) Protects Tribune's Shareholder Payments Because Tribune Was a "Financial Institution" (i.e., Covered Entity)

As a result of *Merit Management*, the Second Circuit considered whether Tribune (as transferor of the payments) and/or its shareholders (as transferees) constituted Covered Entities. The Second Circuit held that the safe harbor still protected the shareholder payments because, tracking the Bankruptcy Code definition of a "financial institution," Tribune was the "customer" of a trust company and bank, CTC, that was "acting as agent" for Tribune "in connection with a securities contract," the tender-offer repurchase and redemption of Tribune's shares from its shareholders.[13] The District Court had reached the same conclusion on April 23, 2019 in a related action brought by the trustee under Tribune's chapter 11 plan.[14]

The Second Circuit's decision rested on four premises: (1) CTC is a "financial institution" because it appears on the Office of the Comptroller of the Currency's list of trust companies and banks; (2) Tribune was CTC's "customer," within the "ordinary meaning" of that term, because "Tribune retained [CTC]

to act as 'Depositary' in connection with the LBO tender offer"; (3) CTC acted as Tribune's "agent," according to that term's "common-law meaning," because Tribune deposited funds with CTC and entrusted CTC to pay shareholders and receive their shares while Tribune "maintained control over key aspects of the undertaking"; and (4) the payments to shareholders via the tender offer and redemption were "in connection with a securities contract" based on the Bankruptcy Code's "capacious[]" definition of a "securities contract."[15] Thus, the Second Circuit held that the safe harbor protected the payments to all shareholders because they were made by a Covered Entity, Tribune.

The Second Circuit also reaffirmed its prior ruling that the safe harbor preempted the creditors' claims. Rejecting the creditors' argument that the safe harbor did not bar their claims because the safe harbor expressly applies only to "the trustee" in bankruptcy, the Second Circuit concluded that "[e]very congressional purpose reflected in Section 546(e), however narrow or broad, is in conflict with appellants' legal theory."[16] It reasoned that "[u]nwinding settled securities transactions by claims such as appellants' would seriously undermine − a substantial understatement − markets in which certainty, speed, finality, and stability are necessary to attract capital."[17]

IV. Conclusion

Whereas *Merit Management* raised the specter that the safe harbor under section 546(e) of the Bankruptcy Code might be limited to transactions between traditional Covered Entities (e.g., stockbrokers, banks, securities clearing agencies), *Tribune* demonstrates that the safe harbor may still protect securities transactions between parties that might not otherwise constitute Covered Entities (e.g., a publishing and media company such as Tribune) where a financial institution acts as agent in effectuating the transaction and the other requirements outlined above are met. *Tribune*'s preemption ruling is also important because it confirms that creditors cannot "end run" the safe harbor by bringing state law constructive fraudulent conveyance claims outside of a bankruptcy case.[18] However, *Tribune* is not binding on other circuits, and, given the decision's focus on protecting the public markets, it remains to be seen whether courts will extend its holding to different circumstances (e.g., private securities transactions).

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[1] Gibson, Dunn & Crutcher LLP represents certain shareholders and directors in this litigation.

[2] 11 U.S.C. § 546(e).

[3] *Tribune*, 2019 WL 6971499, at *17.

[4] The decision is discussed in greater detail in our previous client alert. *See* Garza, Oscar, Rosenthal, Michael & Levin, Douglas, Supreme Court Settles Circuit Split Concerning Bankruptcy Code "Safe Harbor" (Mar. 5, 2018).

[5] 138 S. Ct. at 897.

[6] *See* 11 U.S.C. § 101(22)(A) ("The term 'financial institution' means … a Federal reserve bank, or an entity that is a commercial or savings bank, industrial savings bank, savings and loan association, trust company, federally-insured credit union, or receiver, liquidating agent, or conservator for such entity and, when any such Federal reserve bank, receiver, liquidating agent, conservator or entity is acting as *agent or custodian* for a *customer … in connection with a securities contract … such customer*[.]") (emphases added).

[7] *See* 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.").

[8] *See In re Tribune Co. Fraudulent Conveyance Litig.*, Case No. 11-md-2296 (DLC) (S.D.N.Y.).

[9] *See In re Tribune Co. Fraudulent Conveyance Litig.*, 499 B.R. 310, 320 (S.D.N.Y. 2013) ("[T]he Court concludes that Congress said what it meant and meant what it said, … as such, Section 546(e) applies only to the trustee and does not preempt the Individual Creditors' SLCFC claims").

[10] *See In re Tribune Co. Fraudulent Conveyance Litig.*, 818 F.3d 98, 109-24 (2d Cir. 2016).

[11] *See Deutsche Bank Tr. Co. Americas v. Robert R. McCormick Found.*, 138 S. Ct. 1162 (2018).

[12] *Tribune*, 2019 WL 6971499, at *6.

[13] *Id*. at *6-9.

[14] *See In re Tribune Co. Fraudulent Conveyance Litig.*, 2019 WL 1771786 (S.D.N.Y. Apr. 23, 2019). The decision is discussed in greater detail in our previous client alert. *See* Garza, Oscar, Levin, Douglas & Bouslog, Matthew, S.D.N.Y. Decision May Have Significant Impact on Bankruptcy Code "Safe Harbor" for Securities Transactions (Apr. 29, 2019).

[15] *Tribune*, 2019 WL 6971499, at *6-9.

[16] *Id.* at *17.

[17] *Id.*; *see also id*. at *19 ("A lack of protection against the unwinding of securities transactions would create substantial deterrents, limited only by the copious imaginations of able lawyers, to investing in the securities market. The effect of appellants' legal theory would be akin to the effect of eliminating the limited liability of investors for the debts of a corporation: a reduction of capital available to American securities markets.").

[18] Although *Tribune* only involved constructive fraudulent conveyance claims, the decision provides a basis to argue that analogous state law claims (e.g., unjust enrichment) are also preempted.

Gibson, Dunn & Crutcher's lawyers are available to assist with any questions you may have regarding these issues. For further information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Business Restructuring and Reorganization practice group, or any of the following:

Oscar Garza - Orange County, CA (+1 949-451-3849, ogarza@gibsondunn.com)
Douglas G. Levin - Orange County, CA (+1 949-451-4196, dlevin@gibsondunn.com)
Matthew G. Bouslog - Orange County, CA (+1 949-451-4030, mbouslog@gibsondunn.com)

Please also feel free to contact the following practice group leaders:

Business Restructuring and Reorganization Group:

David M. Feldman - New York (+1 212-351-2366, dfeldman@gibsondunn.com)
Scott J. Greenberg - New York (+1 212-351-5298, sgreenberg@gibsondunn.com)
Robert A. Klyman - Los Angeles (+1 213-229-7562, rklyman@gibsondunn.com)
Jeffrey C. Krause - Los Angeles (+1 213-229-7995, jkrause@gibsondunn.com)
Michael A. Rosenthal - New York (+1 212-351-3969, mrosenthal@gibsondunn.com)