April 29, 2019

Bankruptcy "Safe Harbor" Fraudulent Transfer Defense Reaffirmed in Tribune LBO Litigation

On April 23, 2019, Ropes & Gray, representing a large group of shareholder defendants, won a decision in the U.S. District Court for the Southern District of New York that provides potential fraudulent transfer protection for payments made to shareholders in leveraged buyouts, stock redemptions and other securities transactions.

Constructive Fraudulent Transfer Claims and the Securities Safe Harbor

The Bankruptcy Code empowers bankruptcy trustees to avoid certain "constructively fraudulent" transfers made when an insolvent debtor receives less than reasonably equivalent value in exchange for transfers of cash or other assets. When bankruptcy follows a leveraged buyout or leveraged recapitalization, it is common for a creditors committee or bankruptcy trustee to sue shareholders to claw back merger consideration or other payments received for securities. Although a "securities safe harbor" under Bankruptcy Code section 546(e) shields from avoidance transfers that are settlement payments or related to a securities contract, when those transfers are "made ***by or to*** (or for the benefit of) . . . financial institutions," in February 2018, the Supreme Court held that the safe harbor does not apply if the financial institution was merely an intermediary in the transaction. *Merit Management Group, LP v. FTI Consulting, Inc.*, 137 S. Ct. 2092 (2017) ("*Merit Management*"). *Merit Management* significantly narrowed the scope of Section 546(e), which had previously been interpreted to protect any transfer made through a financial institution. However, this Supreme Court decision left undecided other potential avenues to broadly protect shareholder transfers under the safe harbor.

In *In re Tribune Company Fraudulent Conveyance Litigation*, No. 11md2296 (S.D.N.Y. Apr. 23, 2019), U.S. District Court Judge Cote ruled that payments in a leveraged buyout to thousands of shareholders are protected because having a traditional financial institution (*e.g.*, a commercial bank or trust company) as an intermediary in the transaction can qualify the company making the payments (in this case, Tribune) as itself a "financial institution" within the meaning of Bankruptcy Code section 546(e). Specifically, Judge Cote held that the safe harbor's statutory definition of "financial institution" included Tribune, as the transferor, because Tribune was a "customer" of Computershare Trust Company (the depositary for the LBO), and CTC acted as Tribune's agent in the transaction. Judge Cote held that the payments were made "***by*** . . . a financial institution" and were "in connection with a securities contract" (a term that courts define very broadly), thus qualifying for the safe harbor, notwithstanding *Merit Management*.

The *Tribune* Decision

The Tribune litigation arose out of the 2007 leveraged buyout of the Tribune Company and its subsequent bankruptcy in 2008. In 2010, the unsecured creditors committee on Tribune's bankruptcy estate ("Committee") filed a suit seeking to recover over $8 billion of payments made to over 5,000 former shareholder defendants. The Committee, however, asserted only "intentional" fraudulent transfer claims because at that time, prior to *Merit Management*, it was clear under applicable law that the Section 546(e) safe harbor barred constructive fraudulent transfer claims for payments made through banks or trust companies. Following *Merit Management*'s narrowing of the Section 546(e) safe harbor, the litigation trustee, as successor to the Committee, moved to amend the complaint to add constructive fraudulent transfer claims. Judge Cote denied the motion for two independent reasons: (i) amendment would be futile because Section 546(e) continues to bar constructive fraudulent transfer claims, and (ii) amending the complaint at this time, more than ten years after the transactions at issue, would be prejudicial to thousands of defendants. The same Section 546(e) argument has already been briefed in the Second Circuit Court of Appeals in a related litigation initiated under state law by Tribune's individual creditors. We expect that the litigation trustee will seek Second Circuit review of Judge Cote's latest order as well.

Implications

The *Tribune* decision provides a road map to secure bankruptcy safe harbor defenses for payments made in leveraged buyouts, certain leveraged recapitalizations, and other similar transactions. The Supreme Court's *Merit Management* decision disrupted a widely recognized interpretation of the Bankruptcy Code that protected many transactions from constructive fraudulent transfer risk if they were effected through financial institutions as intermediaries. Judge Cote's opinion reaffirms the Bankruptcy Code's previous protection from constructive fraudulent transfer claw back claims as long as the company making the payments is a "customer" of a traditional financial institution, and that financial institution acts as the company's agent in making the payments. Although not specifically addressed, the reasoning of Judge Cote's decision would similarly protect transfers where the recipient meets those same "financial institution" criteria (it is a "customer" of a traditional financial institution and that financial institution acts as the recipient's agent).

The *Tribune* decision is the first significant decision to consider how the safe harbor applies in the wake of *Merit Management*. While Judge Cote's reasoning is persuasive and the S.D.N.Y. District Court is influential, the ruling is not binding on other District Court judges. We anticipate that the Second Circuit will review this decision, and its ruling could further alter the availability of the safe harbor.

For more information regarding this recent decision, or to discuss fraudulent transfer litigation risk generally, please feel free to contact Mark Bane, Steve Moeller-Sally, Andrew Devore, or Joshua Sturm from our business restructuring group or Will Shields, Neill Jakobe or David Blittner from our private equity transactions group or your usual Ropes & Gray advisor.