April 20, 2021

Second Circuit *Tribune* Decision Stands—Providing Bankruptcy Code "Safe Harbor" Protection for LBOs

Attorneys
Andrew G. Devore
Gregg M. Galardi
Ryan Preston Dahl
William M. Shields
Neill P. Jakobe
David Blittner
Douglas Hallward-Driemeier
Loretta R. Richard

In a case with wide-reaching implications for the private equity industry, the U.S. Supreme Court ended a decade-long effort by distressed debt investors to undermine the safe harbor from avoidance actions set forth in Section 546(e) of the Bankruptcy Code. On April 19, 2021, the Supreme Court denied a petition for certiorari in the *In re Tribune Company Fraudulent Conveyance Litigation ("Tribune")*, preserving the safe harbor defense for LBOs established by the influential Second Circuit. The Second Circuit's *Tribune* decision reaffirmed the vitality of the securities safe harbor in the context of LBO and leveraged recapitalization transactions notwithstanding the Supreme Court's 2018 decision in *Merit Management*, a decision that was initially believed to have dramatically restricted the scope of the safe harbor. Ropes & Gray serves as court-appointed liaison counsel for the approximately 5,000 public shareholder defendants in the *Tribune* case.

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. Similarly, the Bankruptcy Code permits avoidance of transfers that were "intentionally fraudulent" as to creditors. 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 the "securities safe harbor" under Bankruptcy Code Section 546(e) shields from most avoidance actions[1] transfers that are settlement payments or payments 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 is merely an intermediary in the transaction. *Merit Management Group, LP v. FTI Consulting, Inc.,* 137 S. Ct. 2092 (2017) ("*Merit Management*"). *Merit Management* was initially viewed as significantly narrowing the scope of the Section 546(e) securities safe harbor. However, *Merit Management* left undecided other potential arguments to broadly protect shareholder transfers under the safe harbor.

The *Tribune* LBO and Avoidance Litigation

A year after its 2007 leveraged buyout in which public shareholders received over $8 billion in payments principally funded with new LBO debt, the Tribune Company—the storied newspaper and media company—filed for bankruptcy. As part of its chapter 11 plan, avoidance actions against the former public shareholders were preserved for the benefit of pre-LBO bondholders, including distressed debt investors that purchased bonds as a litigation play for the potential upside of the fraudulent transfer actions.

In an effort to escape the safe harbor—which by its terms only applies to claims brought by the bankruptcy "trustee"—the Tribune chapter 11 plan permitted the indenture trustees for the bonds to bring constructive fraudulent transfer claims under state fraudulent transfer law. By having the indenture trustees (the creditors) bring the constructive fraudulent

[1] The only type of fraudulent transfer claims that are not precluded by the safe harbor are intentional fraudulent transfer claims brought under Section 548 of the Bankruptcy Code. Such intentional fraudulent transfer claims can only be brought by a bankruptcy trustee if the transaction at issue occurred within two years prior to the bankruptcy. Thus, so long as the attacked transaction occurred more than two years prior to a bankruptcy of the transferor, all fraudulent transfer actions are subject to the safe harbor defense.

ATTORNEY ADVERTISING

transfer claims instead of the bankruptcy trustee, the plaintiffs attempted to end-run the Section 546(e) safe harbor defense.

The indenture trustees' constructive fraudulent transfer claims were dismissed by the Southern District of New York in 2013. On appeal, the Second Circuit affirmed dismissal based on the Second Circuit's then-existing precedent that afforded safe harbor protection where financial institutions were intermediaries in the transaction. The Second Circuit also held that Section 546(e) precluded the creditors' attempted end run of the safe harbor as a matter of federal preemption of state fraudulent transfer laws. While the plaintiffs' petition for certiorari in *Tribune* was pending in the Supreme Court, the Supreme Court took another case on the safe harbor, *Merit Management*. Following its decision adverse to LBO defendants in that case, the Supreme Court encouraged the Second Circuit to reconsider the *Tribune* case.

In December 2019, the Second Circuit amended its decision, reaffirming its holding that the safe harbor precluded the fraudulent transfer claims notwithstanding the decision in *Merit Management*. *In re Tribune Company Fraudulent Conveyance Litigation*, 946 F.3d 66 (Dec. 19, 2019). The Second Circuit held that Section 546(e)'s requirement that the transfer be "by or to" a financial institution was satisfied because Tribune, as the transferor, itself qualified as a "financial institution" under the statutory definition. This was because the Bankruptcy Code defines a "financial institution" to include not only commercial banks, trust companies, and other entities commonly understood as "financial institutions," but also "customers" of such financial institutions when the financial institution is acting as their "agent" in connection with a securities contract. The Second Circuit held that Tribune qualified as a statutory "financial institution" because Tribune was a "customer" of Computershare Trust Company (the depositary for the LBO), and Computershare acted as Tribune's agent in the transaction.

The plaintiffs filed a second petition for certiorari in the Supreme Court. After inviting the views of the U.S. Solicitor General, which recommended against granting review, the Supreme Court denied the petition for certiorari on April 19, 2021.

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 Second Circuit's opinion—now firmly established law in the influential Second Circuit—reaffirms the Bankruptcy Code's protection from most fraudulent transfer clawback 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 connection with a securities contract.

Under *Tribune*, selling shareholders can obtain the protection of the safe harbor by using a bank or trust company as an agent in the transaction. While this is already commonplace in public company buyouts through the use of banks or trust companies as "depositaries" or "paying agents" in handling the exchange of shares for cash, this roadmap could also be applied to non-public company stock transactions and LBOs. Similarly, under the rationale in *Tribune*, structuring asset sales as stock transactions in the same manner can also preserve safe harbor defenses.

For more information regarding this decision, or to discuss how a bank or trust company could act as an "agent" in a securities transaction, please feel free to contact Andrew Devore, Gregg Galardi, or Ryan Preston Dahl from our business restructuring group, Will Shields, Neill Jakobe or David Blittner from our private equity transactions group, Douglas Hallward-Driemeier from our appellate and Supreme Court practice, Loretta Richard in our tax and benefits practice, or your usual Ropes & Gray advisor.

This alert should not be construed as legal advice or a legal opinion on any specific facts or circumstances. This alert is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. The contents are intended for general informational purposes only, and you are urged to consult your attorney concerning any particular situation and any specific legal question you may have. © 2021 Ropes & Gray LLP

ATTORNEY ADVERTISING