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Feature

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Second Circuit Breathes New Life into § 546(e), Answering Unaddressed Question by *Merit*

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On Dec. 19, 2019, in *In re Tribune Co. Fraudulent Conveyance Litigation*,[1] the Second Circuit held that the safe-harbor provision in § 546(e) of the Bankruptcy Code barred claims seeking to claw back payments that Tribune Co. made to public shareholders in 2007 as part of a go-private transaction. This 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" as defined in the Bankruptcy Code, which includes a "customer" of a financial institution when the financial institution acts as the customer's "agent or custodian ... in connection with a securities contract."[3] The court 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)."[4]

The decision is significant in the wake of the U.S. Supreme Court's 2018 ruling in *Merit Management Group LP v. FTI Consulting Inc.*, which limited the scope of the safe harbor and led many to question whether the safe harbor still protects securities transactions such as those in *Tribune*.[5] *Tribune* signals that, at least in the Second Circuit, the safe harbor might still protect securities transactions where a financial institution acts as agent or custodian for the transferor or transferee as its customer.

Overview of the § 546(e) Safe Harbor

Section 546(e) limits a trustee's avoidance powers as follows:

> Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment ... or settlement payment ... made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract securities contract ... commodity contract ... or forward contract ... except under section 548(a)(1)(A).[6]

Section 546(e) thus prohibits a trustee from avoiding, as a constructive fraudulent transfer, a "settlement payment" or a transfer "in connection with a securities contract" that is "made by or to (or for the benefit of)" a "financial institution."[7]

The Supreme Court's Decision in *Merit Management*

Prior to *Merit Management*, multiple circuits, including the Second Circuit, held that the safe

1 __ F.3d __, 2019 WL 6971499 (2d Cir. Dec. 19, 2019). The authors and their firm represent certain defendants in this litigation.
2 11 U.S.C. § 546(e).
3 *In re Tribune*, 2019 WL 6971499, at *6-9.
4 *Id.* at *17.
5 138 S. Ct. 883 (2018).
6 11 U.S.C. § 546(e).
7 Section 546(e) expressly preserves a trustee's cause of action for actual (or intentional) fraudulent transfer under § 548(a)(1)(A). *Id.*

harbor in § 546(e) protects transfers from being avoided as constructively fraudulent if the funds at issue passed *through* a financial institution or another covered entity acting as a conduit, even if neither the transferor nor the transferee was itself a covered entity.[8] The Supreme Court in *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.[9] Thus, *Merit Management* narrowed the scope of the safe harbor in those circuits.

Although the Bankruptcy Code defines a "financial institution" to include a "customer" of a "financial institution" under certain circumstances,[10] *Merit Management* expressly declined to address whether § 546(e) protects a transfer made by or to a party that constitutes a protected "customer" but is not otherwise a covered entity. In a footnote, the Supreme Court acknowledged that it left the issue undecided because the defendant had failed to make the argument.[11] Thus, the Court left the question of whether and under what circumstances § 546(e) protects the customer of a financial institution unaddressed and for lower courts to subsequently resolve. That open question was decided in *Tribune*.

Background in *Tribune*

In 2007, Tribune, a public company, borrowed approximately $11 billion to refinance existing bank debt and consummate a leveraged buyout consisting of a tender offer followed by a merger six months later.[12] Tribune transmitted the funds to Computershare Trust Co. NA, which held the funds and made the payments to shareholders on Tribune's behalf.[13] Computershare acted as a "depositary" in connection with the tender offer by receiving shares tendered by shareholders and making payments to them, and it subsequently paid shareholders for stock that was redeemed (or canceled) in the merger.[14]

One year after consummating the merger, on Dec. 8, 2008, Tribune and various subsidiaries commenced chapter 11 cases.[15] 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.[16] The creditors commenced lawsuits in various jurisdictions that were consolidated in a multi-district litigation in the U.S. District Court for the Southern District of New York.[17] The defendants moved to dismiss the claims on certain grounds, including that they were barred by the safe harbor in § 546(e). 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.[18]

The Second Circuit affirmed the dismissal, but agreed with the defendants and held that § 546(e) preempted the creditors' state law claims, even though the safe harbor expressly refers only to claims brought by "the trustee."[19] The creditors filed a petition for *certiorari* in the Supreme Court, which was pending when the Court accepted, then decided, *Merit Management*. After issuing its decision in *Merit Management*, the Court issued a statement noting that consideration of the *cert* petition would be further deferred because there was a possibility of a lack of quorum,[20] and allowing the Second Circuit to consider whether to recall the mandate to reconsider its ruling in *Tribune* in light of *Merit Management*.[21] Because the Second Circuit's previous decision held that the safe harbor protected Tribune's shareholder payments because the funds 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."[22]

Section 546(e) Protects Shareholder Payments Because Tribune Was Itself a "Financial Institution"

The Second Circuit held that § 546(e) still protected the shareholder payments because, tracking the Bankruptcy Code's definition of a "financial institution," Tribune was the "customer" of a trust company and bank, Computershare, that was "acting as agent" for Tribune "in connection with a securities contract" and the repurchase and redemption of Tribune's shares.[23] A few months earlier, on April 23, 2019, the district court reached the same conclusion based on similar grounds in a related lawsuit brought by the litigation trustee appointed under Tribune's chapter 11 plan.[24]

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

8 Prior to the Supreme Court granting *certiorari* in *Merit*, the breadth of the § 546(e) safe harbor had created a split among no less than five other circuit courts of appeals: the Tenth Circuit (*In re Kaiser Steel Corp.*, 952 F.2d 1230 (10th Cir. 1991)), the Eleventh Circuit (*In re Munford Inc.*, 98 F.3d 604 (11th Cir. 1996)), the Third Circuit (*In re Resorts Int'l Inc.*, 181 F.3d 505, 516 (3d Cir. 1999)), the Sixth Circuit (*In re QSI Holdings Inc.*, 571 F.3d 545, 548 (6th Cir. 2009)); and the Second Circuit (*Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329, 339 (2d Cir. 2011), and *In re Quebecor World (USA) Inc.*, 719 F.3d 94, 99 (2d Cir. 2013)). *See FTI Consulting Inc. v. Merit Mgmt. Grp. LP*, 830 F.3d 690 (7th Cir. 2016), *petition for cert. filed*, 86 USLW 4088 (U.S. Dec. 13, 2016) (No. 16-784) at 9-13, *available at* scotusblog.com/wp-content/uploads/2016/12/16-784-cert-petition.pdf (last visited Feb. 4, 2020).

9 138 S. Ct. at 897.

10 *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*.") (emphasis added).

11 *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.").

12 *In re Tribune*, 2019 WL 6971499, at *1; *see also In re Tribune Co. Fraudulent Conveyance Litig.*, 2018 WL 6329139, at *2-4 (S.D.N.Y. Nov. 30, 2018) (discussing tender offer and merger transactions), *reconsideration denied*, 2019 WL 549380 (S.D.N.Y. Feb. 12, 2019).

13 *In re Tribune*, 2019 WL 6971499, at *7, *9.

14 *Id.*

15 *Id.* at *2.

16 *Id.*

17 *Id.* at *3.

18 *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.").

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

20 28 U.S.C. § 2109.

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

22 *In re Tribune*, 2019 WL 6971499, at *6.

23 *Id.* at *6-9.

24 *See In re Tribune Co. Fraudulent Conveyance Litig.*, 2019 WL 1771786 (S.D.N.Y. April 23, 2019). This ruling is on appeal to the Second Circuit as of late January 2020. *See In re Tribune Co. Fraudulent Conveyance Litig.*, Case No. 19-3049-cv, Dkt. No. 133 (2d Cir. Jan. 7, 2020).

to act as 'Depositary' in connection with the [leveraged buyout] tender offer"; (3) Computershare acted as Tribune's "agent," according to that term's "common law meaning," because Tribune deposited funds with Computershare and entrusted Computershare 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 merger were "in connection with a securities contract" based on the Bankruptcy Code's "capacious" definition of a "securities contract."[25] 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 § 546(e) safe harbor preempts the creditors' state law claims. Rejecting the creditors' argument that the safe harbor does 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."[26] 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."[27]

On Jan. 2, 2020, the creditors filed a petition for panel rehearing and rehearing *en banc*, arguing that the Second Circuit issued its ruling based on an inadequate record.[28] The creditors also argued that the Second Circuit reached the wrong result because certain affiliates of Computershare purportedly "processed the [shareholder] payments" (not Computershare, as the Second Circuit assumed), and Computershare was not Tribune's "agent" because Computershare did not owe "certain fiduciary duties" to Tribune and lacked the power to "bind" Tribune or "affect [its] legal rights and duties."[29] As of late January 2020, the Second Circuit has not ruled on the creditors' petition.

Conclusion

By rejecting the "conduit" theory, *Merit Management* raised the specter that the § 546(e) safe harbor might be limited to transactions between specifically defined covered entities (*e.g.*, stockbrokers, financial institutions and securities clearing agencies). *Tribune* demonstrates that the safe harbor might still protect securities transactions between parties that are not defined covered entities (*e.g.*, a publishing and media company such as Tribune), where a "financial institution" (*e.g.*, bank or trust company) acts as "agent" for the transferor or transferee as its "customer" in connection with a securities contract.

Because *Tribune* is not binding on other circuits, it remains to be seen whether other courts will follow *Tribune*, extend its holding to different circumstances, or limit it to public securities transactions given the decision's focus on protecting public markets. Courts could also seek to distinguish *Tribune* based on the unique facts of that case (*e.g.*, a large public securities transaction involving payments to thousands of shareholders), including the relationship between Computershare (as the "agent") and Tribune (as the "customer"). Finally, *Tribune*'s preemption ruling is also significant because it confirms that, at least in the Second Circuit, creditors cannot "end run" the safe harbor by bringing state law constructive fraudulent-conveyance claims outside of a bankruptcy case.[30] abi

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25 *In re Tribune*, 2019 WL 6971499, at *6-9.
26 *Id.* at *17.
27 *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.").
28 *See In re Tribune Co. Fraudulent Conveyance Litig.*, Case No. 13-3992-cv(L), Dkt. No. 435 (2d Cir. Jan. 2, 2020).
29 *Id.* at 9-13. Many of these same arguments were also made in the appeal from the district court's ruling (*see supra* n.23).

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