District Court Applies Section 546(e) Safe Harbor to Customer of Financial Institution, Revitalizing Key Defense

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A recent decision from the U.S. District Court for the Southern District of New York has breathed new life into the Bankruptcy Code Section 546(e)'s securities transaction safe harbor for fraudulent conveyance actions.[1] Judge Denise Cote of the Southern District of New York denied a motion brought by the litigation trustee (the trustee) for the Tribune Company (Tribune) litigation trust, which sought to add federal constructive fraudulent transfer claims related to the 2007 leveraged buyout (LBO) of Tribune, holding that such claims were barred by the safe harbor provided in Bankruptcy Code Section 546(e).[2] In so holding, Judge Cote found that Tribune was a "financial institution" covered by the safe harbor due to its status as a "customer" of a bank/trust company acting as its "agent" in the challenged LBO transactions, which were "in connection with" a securities contract.

Judge Cote's decision in *Tribune* is the first published decision (outside of proceedings related to *Merit*) applying the U.S. Supreme Court's 2018 decision in *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*[3] As we previously noted in an earlier client alert, ("Bankruptcy Code's Safe Harbor 'Conduit' Defense Eliminated by Supreme Court; Variant Defense May Survive") the Bankruptcy Code's definition of "financial institution" revitalizes the Section 546(e) safe harbor defense for fraudulent conveyance defendants.

Merit Management's Curtailment of the Safe Harbor

Bankruptcy Code Section 546(e) bars a bankruptcy trustee from avoiding "a transfer that is … a settlement payment … made by or to (or for the benefit of) … a financial institution … in connection with a securities contract."[4] On February 27, 2018, the Supreme Court unanimously held in *Merit* that "the only relevant transfer for purposes of the safe harbor is the transfer that the trustee seeks to avoid." In ruling that courts should focus on the "overarching transfer" — the one subject to a trustee's challenge — the Supreme Court effectively made any intermediate "component transactions" irrelevant for the purposes of the Section 546(e) safe harbor. The *Merit* decision thus eliminated the "conduit" defense for fraudulent conveyance actions.

Foreshadowing a New Approach

Notwithstanding its ruling in *Merit*, the Supreme Court identified another potential tool for defending against fraudulent conveyance actions — the "customer" defense. In particular, "financial institutions" are among the types of transfer parties covered under Section 546(e), and the Bankruptcy Code's definition of "financial institution" includes a "customer" of one of several enumerated types of entities when such entity "is acting as agent or custodian" for such customer "in connection with a securities contract."[5] During oral arguments in *Merit*, Justice Stephen Breyer suggested that this definition may be dispositive of the question before the Court.[6] However, neither party raised the issue, and the Supreme Court ultimately left open the question of whether the

[1] Skadden currently represents, among others, certain of the selling shareholders in the underlying action, as well as members of the special committee for the board of directors of Tribune Company.

[2] *In re Tribune Co. Fraudulent Conveyance Litig.*, No. 11MD2296 (DLC), 2019 WL 1771786 (S.D.N.Y. Apr. 23, 2019).

[3] *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, 138 S. Ct. 883 (2018).

[4] 11 U.S.C. § 546(e).

[5] 11 U.S.C. § 101(22).

[6] *See also Merit Mgmt.*, 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' …. We therefore do not address what impact, if any, § 101(22)(A) would have in the application of the § 546(e) safe harbor.").

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Bankruptcy Code's inclusion of customers in the definition of "financial institution" might leave open a customer's ability to avail itself of the safe harbor.

The *Tribune* Case

In 2007, Tribune completed a two-step LBO, in which Tribune purchased all of its outstanding stock from then existing shareholders for approximately $8 billion. To effect the exchange, Tribune transferred the cash required to repurchase its shares to Computershare Trust Company (CTC), which remitted payment to Tribune's shareholders in exchange for their stock. Soon after the LBO, Tribune experienced financial difficulty and ultimately filed for bankruptcy.

The Bankruptcy Court granted standing to the official committee of unsecured creditors of Tribune (UCC) to assert claims against various defendants on behalf of Tribune's estate. The UCC in turn filed a complaint that included an intentional fraudulent transfer claim. Tribune's plan of reorganization transferred the UCC's claims to a litigation trust; certain disclaimed state law avoidance claims, however, expressly were not transferred to the litigation trust.

The Bankruptcy Court granted Tribune's creditors relief from the automatic stay to allow them to pursue state law constructive fraudulent conveyance claims, which were not asserted by the debtors' estates before the applicable statute of limitations. The individual creditors of Tribune filed numerous lawsuits against Tribune's former shareholders, seeking to recover the consideration paid to them as part of the LBO. These lawsuits were consolidated in the Southern District of New York. Among the actions brought against Tribune's shareholders were various state law constructive fraudulent transfer claims, which the District Court dismissed for lack of standing.[7] On appeal, the Second Circuit affirmed the lower court's dismissal, but on different grounds — namely, that Section 546(e) pre-empted the claims.[8]

The District Court's Ruling

Following the *Merit* decision, the Tribune litigation trustee sought leave to add constructive fraudulent transfer claims under the Bankruptcy Code.

The parties in *Tribune* agreed that the transfers at issue were "in connection with a securities contract," but disagreed as to whether, by virtue of being a customer of the bank handling the transfers, Tribune itself was covered under Section 546(e) as a "financial institution." In particular, Tribune's former shareholders argued that because Tribune — as a customer of CTC — employed CTC as its agent in the challenged transfers, Tribune was itself a financial institution under the Bankruptcy Code.

After analyzing the ordinary meaning of "customer" and the common law definition of "agent," the District Court determined that the relationship between Tribune and CTC meant that, for the purposes of the cash-for-stock exchange with Tribune's shareholders, Tribune qualified as a "financial institution" under the Bankruptcy Code. The Section 546(e) safe harbor thus applied, barring the trustee's newly asserted claims.

The District Court rejected the notion that its holding conflicted with the spirit of the *Merit* decision, pointing out that the Supreme Court explicitly left open the question of whether a transferor or transferee in a transfer subject to an avoidance action can qualify as a financial institution by virtue of its status as a customer of a financial institution. The District Court further explained that its ruling was in line with Section 546(e)'s goal of "promoting stability and finality in securities markets and protecting investors from claims precisely like" those asserted by the trustee.

The Birth of the 'Customer' Defense?

As foreshadowed by Justice Breyer in *Merit*, Judge Cote's ruling in *Tribune* ushers in a reincarnated form of the 546(e) safe harbor in the form of the "customer" defense. Whereas the now defunct "conduit" defense focused on which parties were involved in a given transaction, the "customer" defense focuses on the nature of the relationship between the parties to the overarching transfer and any banks or other financial institutions facilitating the transaction. It remains to be seen whether the Supreme Court ultimately has the opportunity to weigh in again — *Tribune* is subject to appeal — but, for now, the Section 546(e) safe harbor has new vitality. As a result, the *Tribune* decision is likely to give commercial parties greater peace of mind when structuring financial transactions.

[7] *In re Tribune Co. Fraudulent Conveyance Litig.*, 499 B.R. 310 (S.D.N.Y. 2013), *aff'd on other grounds*, 818 F.3d 98 (2d Cir. 2016).

[8] *In re Tribune Co. Fraudulent Conveyance Litig.*, 818 F.3d 98 (2d Cir. 2016).