ALERT MEMORANDUM

District Court Clarifies Application of Anti-Avoidance Safe Harbor to Customers of Financial Institutions

May 16, 2019

On April 23, 2019, Judge Cote of the U.S. District Court for the Southern District of New York issued an opinion that clarifies when a customer of a bank may be a "financial institution" for purposes of the U.S. Bankruptcy Code's (the "Code") anti-avoidance safe harbors.[1] The court held that, because the Tribune Company ("Tribune") used a trust company as a depositary and exchange agent to repurchase its own shares, it was itself a "financial institution" for purposes of the Code. As a result, the shareholders who sold their shares back to Tribune could avail themselves of the anti-avoidance protections for settlement payments set forth in Section 546(e) of the Code.

The district court's decision resolves an issue that the Supreme Court raised in its recent *Merit Management* opinion and may limit the impact of that decision going forward.[2]

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[1] *In re Tribune Co. Fraudulent Conveyance Litigation*, 2019 WL 1771786 (S.D.N.Y. April 23, 2019).
[2] *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, 138 S. Ct. 883 (2018).

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Background

In 2007, Tribune entered into a two-step leveraged buyout ("LBO") to repurchase its outstanding stock through the Computershare Trust Company, N.A. ("CTC").[3] CTC acted as a "Depositary" in the first step, accepting shares on Tribune's behalf and paying the shareholders the purchase price, and as an "Exchange Agent" in the second half, performing generally the same function.[4] In 2008, Tribune experienced financial difficulty and entered into Chapter 11 proceedings.[5] The official committee of unsecured creditors of Tribune (the "UCC") brought an action against Tribune's former shareholders, asserting that the repurchase of Tribune's shares was an intentional fraudulent transfer under Section 548(a)(1)(A) of the Code.[6] The UCC, however, did not assert that the repurchase of the shares was a constructive fraudulent transfer under Section 548(a)(1)(B) of the Code[7] because, at the time, the case law in the Second Circuit (and the Third, Sixth, Eighth and Tenth Circuits) dictated that Section 546(e) of the Code barred such a claim.[8]

Section 546(e) provides, in relevant part, that, "[n]otwithstanding section[] 548(a)(1)(B) of [the Code], the trustee may not avoid a transfer that is a . . . settlement payment . . . made by or to (or for the benefit of) a . . . financial institution [or] financial participant . . . that is made before the commencement of the case, except under section 548(a)(1)(A) of this title." The Code defines "financial institution" to include a bank or trust company. At the time of Tribune's bankruptcy, the Second Circuit had held that a transfer was "by or to" a "financial institution" and thus within the scope of Section 546(e) if the transfer went through such an institution.

In 2018, the U.S. Supreme Court in *Merit Management* rejected the Second Circuit's (and the Third, Sixth, Eighth and Tenth Circuits') view. The Court held that the relevant unit of analysis for Section 546(e) is the "end-to-end" transfer that the trustee seeks to avoid. Only if one of the parties at one of the ends of the transfer is a "financial institution" (or other protected party[9]), the Court held, does Section 546(e) apply. It is not sufficient that a transfer simply go through a bank or trust company.[10]

At the time the *Merit Management* decision was issued, the UCC's federal bankruptcy law claims had been transferred to a litigation trust pursuant to Tribune's plan of reorganization. Following the issuance of the Court's opinion, the litigation trustee sought leave to amend the trust's

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[3] *Id.* at 2.
[4] *Id.* at 2–3.
[5] *Id.* at 3.
[6] Section 548(a)(1)(A) of the Code provides that the trustee may avoid a transfer of an interest of the debtor in property made within two years of the bankruptcy filing if the debtor "made such transfer . . . with actual intent to hinder, delay, or defraud [a creditor]." 11 U.S.C. § 548(a)(1).
[7] Under Section 548(a)(1)(B) of the Code, the trustee may avoid a transfer of an interest of the debtor in property made within two years of the bankruptcy filing if the debtor "(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and (ii)(I) was insolvent on the date [of] that . . . transfer . . . or became insolvent as a result of such transfer or obligation [or under similar circumstances]." 11 U.S.C. § 548(a)(1).
[8] *See In re Quebecor World (USA) Inc.*, 719 F.3d 94 (2d Cir. 2013); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009); *In re QSI Holdings, Inc.*, 571 F.3d 545 (6th Cir. 2009); *In re Resorts Int'l, Inc.*, 181 F.3d 505 (3d Cir. 1999); *In re Kaiser Steel Corp.*, 952 F.3d 1230 (10th Cir. 1991). Tribune's creditors also separately filed constructive state law fraudulent conveyance actions outside of the bankruptcy proceedings. In 2016, the Second Circuit held that Section 546(e) of the Code preempted these actions. *In re Tribune Co. Fraudulent Conveyance Litigation*, 818 F.3d 98 (2d Cir. 2016). After *Merit Management* (discussed below), then-Justice Anthony Kennedy and Justice Clarence Thomas issued a "statement" suggesting the Second Circuit reconsider this holding. The district court's decision did not address the state law claims or the effect *Merit Management* may have on them.
[9] Protected parties under Section 546(e) include commodity brokers, forward contract merchants, stockbrokers, financial institutions, financial participants and securities clearing agencies. 11 U.S.C. § 546(e).
[10] *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, 138 S. Ct. 883 (2018).

complaint to add a federal constructive fraudulent transfer claim under Section 548(a)(1)(B).[11]

Decision

The district court denied the trustee's motion for leave to amend on the grounds that the amendment would be futile: Section 546(e) still precluded the constructive fraudulent transfer action. Even though the "end-to-end" transfer was between Tribune and its shareholders, CTC's role served to make Tribune itself a "financial institution" for purposes of the Code.[12] As a result, the transfer of the purchase price was "by" a financial institution and thus within the scope of Section 546(e).

Although Tribune was not a bank or trust company, the definition of "financial institution" includes not only banks and trust companies, but also "when any [bank or trust company] is acting as agent or custodian for a customer (whether or not a 'customer', as defined in section 741) in connection with a securities contract (as defined in section 741) such customer." In *Merit Management*, the Supreme Court briefly discussed this aspect of the financial institution definition, but ultimately did not determine its contours on the basis that the issue had not been properly presented.

To determine whether Tribune was a financial institution within the meaning of this definition, the district court considered three questions: (1) whether Tribune was a "customer" of CTC; (2) whether CTC acted as Tribune's "agent or custodian;" and (3) whether CTC acted "in connection with a securities contract."[13]

To examine the meaning of "customer" for purposes of the "financial institution" definition, the court looked to the term's "ordinary meaning" in contemporaneous and current dictionaries. Such dictionaries define the term "customer" as including a person who purchases services or goods.[14] The court found that Tribune was a "'purchase[r]' of CTC's 'services'" in connection with the transactions and thus, a customer.[15] The court rejected the litigation trustee's attempt to limit the definition of "customer" to those definitions contained in the Bankruptcy Code.[16] The court held that this interpretation was inconsistent with the text of the "financial institution" definition which states that a customer can be a financial institution when a bank acts as its custodian "whether or not [it is] a 'customer', as defined in section 741."[17] The court found that the term is also not limited to the definition of "customer" given in Section 761 because this "section[] [is] directed to a narrow issue [and] the transactions addressed in Section 546(e) are not."[18]

The court then discussed CTC's role as an "agent" of Tribune. Because "agent" is not defined in the Code, the court looked to the common law to determine whether CTC acted as agent for Tribune. At common law, the court noted, "'[a]gency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the

[11] *Tribune,* 2019 WL 1771786 at 8–10.
[12] *Id.* at 33.
[13] *Id.* at 25. It was undisputed that CTC was a bank or trust company for purposes of the "financial institution" definition.
[14] *Id.* at 26.
[15] *Id.* at 26–27. Notably, although Tribune paid CTC a fee for its services, it is not clear that the court viewed such payment as a requirement for Tribune to constitute a "customer" since the definitions the court cited also included "[i]n banking, any person having an account with a bank or for whom a bank has agreed to collect items." *Id.* at 26 (quoting Black's Law Dictionary (10th ed. 2014)).
[16] *Id.* at 27.
[17] *Id.* at 25–27 (quoting 11 U.S.C. § 101(22)(A)).
[18] *Id.* at 27–28. Section 741 defines "customer" for the purposes of a bankruptcy subchapter dealing with stockbroker liquidation, and Section 761 defines "customer" for the subchapter dealing with commodity broker liquidation.

principal's control, and the agent manifests assent or otherwise consents to so act.'"[19] The court found that because CTC was "entrusted with billions of dollars of Tribune cash and . . . tasked with making payments on Tribune's behalf," the parties clearly had a "paradigmatic" principal-agent relationship.[20]

In reaching this conclusion, the court rejected the litigation trustee's argument that the bank must be acting as agent at the time the avoidance claim is brought. The court concluded that this argument was without merit because both the "financial institution" definition and Section 546(e) are couched in the present tense such that "the Trustee may not avoid, as constructively fraudulent, a transfer that 'is a settlement payment' to a bank or trust company that 'is acting as agent' for its customer, in connection with a securities contract."[21] Because the question of whether a fraudulent transfer is a settlement payment is assessed as of the time of the transfer, so too should the question of whether the bank or trust company is acting as agent for the customer.

Finally, the court turned to whether CTC acted "in connection with a securities contract." Looking to the text of Section 741 and case law, the court determined that a "securities contract" is broadly worded to include contracts "for the purchase or sale of securities" and all "similar or related" agreements.[22] The court held that CTC's repurchase of stock from shareholders at both steps of the LBO "involved the purchase of securities."[23] Therefore, CTC acted "in connection with a securities contract."[24] The final element being met, the court held that Tribune was a financial institution, placing the disputed transfer within Section 546(e)'s safe harbor.

The litigation trustee raised two principal counterarguments as to why Section 546(e) should not apply in this case. First, the trustee argued that applying Section 546(e) would be at odds with a previous judicial decision that the second step of the LBO constituted a merger for purposes of Delaware corporate law and thus could not be viewed as a purchase of securities.[25] The court rejected this contention, noting that the litigation trustee had defined the transfer at issue as "Tribune's payment of cash to its Shareholders."[26] Under *Merit Management*, the trustee is allowed to define the transfer it seeks to avoid. However, the court concluded, the trustee is not then free to ascribe a different characterization to that transfer.[27]

Second, the litigation trustee argued that finding Tribune to be a financial institution would run counter to the spirit of the Supreme Court's decision in *Merit Management*. The court pointed out that *Merit Management* did not address the scope of the definition of a "financial institution," the text of the Code compelled the court's conclusion, and the result of its disposition was consistent with the policy aims of Section 546(e).[28] On the last point, the court found that Section 546(e)'s goal is to promote "stability and finality in securities markets and [to] protect[]

[19] *Id*. at 29 (quoting Restatement (Third) of Agency § 1.01 (2006)).
[20] *Id*. at 30.
[21] *Id* at 30 n. 11. During the *Merit Management* oral argument, this was the principal substantive argument the appellee made to rebut the idea that the transferor in that case was, like Tribune, a financial institution by virtue of being the customer of a bank that acted as agent for the transferor in connection with a securities contract. As noted above, the Court did not ultimately address this argument because it determined that the customer issue had not been properly raised.
[22] *Id.* at 30–31.
[23] *Id.* at 31.
[24] *Id.*
[25] *Id.* at 31–32.
[26] *Id.* at 32 (quoting *Merit Mgmt. Grp., LP v. FTI Consulting, Inc*., 138 S. Ct. at 894).
[27] *Id.* (quoting *Merit Mgmt. Grp., LP v. FTI Consulting, Inc*., 138 S. Ct. at 894).
[28] *Id.* at 32–33.

investors from claims precisely like these."[29] In addition, at the time of the LBO Tribune was a "systemically important" Fortune 500 company and the litigation trustee's constructive fraudulent transfer claims were "precisely the sort of risk that Section 546(e) was intended to minimize."[30] Therefore, the court held that its decision was not at odds with the congressional purpose of the statute or *Merit Management*'s holding that a bank or trust company acting as a conduit is insufficient grounds for a transaction to be safe harbored.

Financial Participant

Although dicta, the court also analyzed whether Tribune was a "financial participant" within the meaning of the Code. Section 101(22A)(A) defines "financial participant" as an "entity that [at certain specified times] has one or more [safe harbored] agreements or transactions . . . with the debtor or any other entity (other than an affiliate)" that exceed certain thresholds.[31] The shareholders argued that the first "entity" in the definition of "financial participant" could refer to "the debtor," i.e., Tribune.[32] The court rejected that view in a brief analysis, stating that it would be "puzzling" for "entity" in the "financial participant" definition to include the "debtor" because the second part of the definition specifically refers to "the debtor or any other entity."[33] Therefore, the court said that Tribune could not be a "financial participant."

This dicta is questionable for a number of reasons. First, the term "entity" in the Code clearly encompasses the debtor. Section 101(15) defines "entity" as including a "person, estate, trust, governmental unit, and the United States trustee." There is no exclusion for the debtor.

Additionally, other definitions in Section 101 contemplate that the debtor is an "entity." For instance, the definition of "insolvent" is based on whether the relevant entity (which will very frequently be the debtor) is a partnership, municipality or other "entity."[34]

Second, interpreting the "financial participant" definition to exclude the debtor would conflict with the language of Section 546(e), which states that a trustee may not avoid a transfer "by or to (or for the benefit of)" of a financial participant. If the debtor is not a financial participant, "by" would be rendered meaningless because there could not be any transfer "by a financial participant" to which Section 546(e) could apply.

Had Congress intended the "financial participant" definition to exclude the debtor, it presumably would have said so directly or provided a clearer indication. For instance, it could have excluded financial participants from the list of the entities included in Section 546(e) and stated instead that the provision only applies to transfers to or for the benefit of such financial participants.

It seems substantially more likely that Congress's intent in using "with the debtor or any other entity" in the "financial participant" definition was simply to clarify that a party could satisfy the contractual thresholds in such definition through either transactions with the debtor or transactions with third parties, not to carve out the debtor from the definition in an exceedingly roundabout manner.

Implications

Tribune demonstrates that the impact of *Merit Management* may be limited. *Merit Management* held that the safe harbor in Section 546(e) does

[29] *Id.*
[30] *Id.*
[31] *Id.* at 23.
[32] *Id.* at 23–24.
[33] *Id.* at 24.
[34] *See* 11 U.S.C. § 101(32).

not apply simply because a transfer passes through a bank or a trust company. *Tribune* clarifies that the definition of "financial institution" may be sufficiently broad to protect a company's transfers when that company conducts such transfers as a "customer" of a financial institution. While *Tribune* provided some clarity, there are still a number of open questions, including, (1) what other relationships could constitute an agency relationship for the purposes of the "financial institution" definition, (2) how might a court define a "custodian" relationship with a bank or trust company and (3) what impact the court's dicta regarding "financial participants" will have on interpretations of Section 546(e).

First, the court in *Tribune* left open questions as to the definition of "financial institution." The court focused on a bank acting as an "agent" in the context of its role as depositary and exchange agent. However, it did not look at other contexts that may prove to be "agency" relationships, such as when a company pays a bank to conduct wire transfers in connection with a transaction. The bounds of what can constitute an agency relationship within the Code are still not fully defined.

Second, the definition of "financial institution" also includes a customer when the bank or trust company is acting as "custodian" for the customer in connection with a securities contract.[35] Unlike "agent," "custodian" is defined in the Code. "Custodian" is defined as a "(A) receiver or trustee of any of the property of the debtor, appointed in a case or proceeding not under [the Code]; (B) assignee under a general assignment for the benefit of the debtor's creditors; or (C) trustee, receiver, or agent under applicable law, or under a contract, that is appointed or authorized to take charge of property of the debtor for the purpose of enforcing a lien against such property, or for the purpose of general administration of such property for the benefit of the debtor's creditors."[36] It is extremely unlikely that a bank or other institution listed in the first part of the "financial institution" definition would act as a receiver or trustee for a customer. Therefore, it would not make sense for a court to use the Code definition. This leaves an open question as to how future courts will define a bank's role as "custodian" within the ambit of Section 741.

Although the court's decision regarding the definition of "financial participant" is dicta,[37] if it is upheld in another court case, it could limit the ability of market participants that face market intermediaries, such as swap dealers, to avail themselves of the safe harbor under Section 546(e). This could increase uncertainty in swaps or other markets regarding the finality of transfers in connection with protected transactions.

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[35] 11 U.S.C. § 101(22).
[36] 11 U.S.C. § 101(11).
[37] *Tribune,* 2019 WL 1771786 at 24.