

# U.S. Supreme Court Declines Review Ending Shareholder Fraudulent Transfer Litigation in Tribune | McGuireWoods

After more than a decade, litigation resulting from the failed leveraged buyout (LBO) of media giant Tribune Company has finally drawn to a close. On Feb. 22, 2022, the U.S. Supreme Court declined to review the latest decision of the U.S. Court of Appeals for the Second Circuit in *In re Tribune Co. Fraudulent Conveyance Litig.*, 10 F.4th 147 (2d Cir. 2021), leaving intact the Second Circuit's decisions affirming dismissal of intentional fraud claims against the Tribune stockholders and the court of appeals' previous decision upholding the stockholders' assertion of the safe harbor defense under Section 546(e) of the Bankruptcy Code.

After the denial of the plaintiffs' certiorari petitions on both intentional and constructive fraudulent transfer grounds, the plaintiffs' avenues for further review are exhausted. As a result, the Second Circuit's rulings stand — Tribune was a “financial institution” protected by the Bankruptcy Code's safe harbor provision — and the LBO payments made to Tribune shareholders cannot be clawed back.

## Fraudulent Transfers and the 546(e) Safe Harbor

Under the Bankruptcy Code, transfers that are fraudulently made and obligations that are fraudulently incurred are avoidable. There are two varieties of fraudulent transfers: actual and constructive. Section 548(a)(1)(A) applies to transfers that are actually fraudulent, i.e., made by the debtor with the actual, subjective intent of defrauding creditors. Section 548(a)(1)(B) targets transfers that are constructively fraudulent.

Rather than focusing on the debtor's intent with respect to making the transfer, establishing a constructively fraudulent transfer turns on the financial position of the debtor and the adequacy of consideration for the transfer. If the debtor was insolvent at the time of the transfer (or shortly thereafter), bankruptcy courts will evaluate whether the debtor received reasonably equivalent value in exchange for the transfer. These two provisions are bolstered by Section 544 of the Bankruptcy Code, which permits a debtor or trustee to assert state law actions for fraudulent transfers (both intentional and constructive) as well.

Despite this, there are certain statutory limitations on the avoidance powers Congress enacted to protect particular types of transactions. Created to prevent the failure of a single market participant from affecting the securities market as a whole, the “securities safe harbor” in Section 546(e) is one of the strongest defenses transferees can raise against fraudulent transfer claims seeking to unwind prebankruptcy securities transactions, such as those that arise out of a failed LBO.

The safe harbor precludes avoidance of transfers (other than those sounding in actual fraud, including intentional fraudulent transfer claims sounding in state law) when the payments are made relating to a securities contract or settlement payments and the transfer is “made by or to (or for the benefit of)” a financial institution. 11 U.S.C. § 546(e). That is, when faced with a transfer that is otherwise avoidable, if that transfer falls within the bounds of that safe harbor, the transfer cannot be avoided.

## Failed LBO and Bankruptcy Filing

In 2007, Tribune was the target of an LBO conceived by real estate mogul Sam Zell. Ultimately, through the LBO, Tribune's shareholders received more than \$8 billion in exchange for their shares in the company.

The LBO occurred in two steps. First, Tribune borrowed \$7 billion and purchased approximately 50% of its outstanding shares in a tender offer. Second, six months later, Tribune bought its remaining shares to complete a go-private merger with a newly formed entity.

Shortly after completing the second step, Tribune experienced financial difficulties because of declining circulation and advertising revenues, leaving it unable to service the debt it took on in the LBO. In December 2008, these difficulties culminated in Tribune filing a Chapter 11 bankruptcy case in Delaware. In July 2012, the U.S. Bankruptcy Court for the District of Delaware confirmed Tribune's plan of reorganization.

### ***Tribune* Avoidance Litigation**

After the Chapter 11 filing, litigation ensued in the bankruptcy court and in multiple state courts. Tribune's confirmed plan assigned the Tribune bankruptcy estate's causes of action to a litigation trust and abandoned certain other claims that vested with the debtor at filing to its creditors. The trustee of this litigation trust was empowered to pursue the litigation trust's causes of action, which included fraudulent transfers to shareholders, breaches of fiduciary duties, violations of Delaware corporate law, and professional malpractice. Several *Tribune* district court rulings were appealed to the Second Circuit.

In a landmark 2019 decision, the Second Circuit affirmed that all state law intentional and constructive fraudulent transfer claims arising from the LBO were preempted by the securities safe harbor in Section 546(e). See *In re Tribune Co. Fraudulent Conveyance Litig.*, 946 F.3d 66 (2d Cir. 2019). The court's inquiry focused on whether the debtor (the transferor) could qualify as a "financial institution" to be covered by the safe harbor, as implied in a footnote in the Supreme Court's decision in *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, by utilizing a bank or trust company as its agent to handle LBO payments, redemptions, and cancellations. 138 S. Ct. 883 (2018). Since Tribune had retained a trust company and bank as its agent to handle the LBO payments to shareholders, the Second Circuit applied the safe harbor.

The trustee appealed this decision, arguing that under *Merit* the trust company and bank was a "mere conduit" of the transaction, and therefore, the safe harbor protections could not be extended to Tribune. In *Merit*, the Supreme Court held that the presence of a financial institution as a "mere conduit" in a transfer does not protect the overall transfer from avoidance. But the Supreme Court left open the question of whether the transfer is protected when the transferor is the financial institution's "customer." *Tribune* answered this question in the affirmative — as long as the transferor entity can establish that it was a "customer" of a financial institution and that such financial institution acted as the transferor's "agent" in connection with a securities contract, the safe harbor applies. The Supreme Court chose not to address the trustee's "mere conduit" argument by denying certiorari. This effectively closed the door on Tribune's creditors recovering the LBO payments from shareholders as constructive fraudulent transfers.

In a 2021 ruling, the Second Circuit affirmed dismissal of the trustee's intentional fraudulent conveyance claims against the shareholders because any "actual intent" of certain of Tribune's directors could not be imputed to Tribune itself. *In re Trib. Co. Fraudulent Conv. Litig.*, 10 F.4th 147, 177 (2d Cir. 2021). The trustee petitioned for certiorari arguing that the court was incorrect in applying the "control" test to determine whether a special board committee, tasked with evaluating the LBO, could be imputed with the actual intent to harm Tribune's creditors. Rather, the trustee argued, Tribune's senior management had the necessary fraudulent intent in executing the LBO, and this intent should be imputed to the special committee and Tribune. On Feb. 22, 2022, the

Supreme Court denied the trustee's petition for a writ of certiorari.

## Outlook

By denying the trustee's certiorari petitions, the Supreme Court ended any speculation that it might utilize the *Tribune* case to address the Section 546(e) safe harbor and the "mere conduit" controversy created by the court's dicta in *Merit*. Additionally, the Second Circuit's decision to adopt the "control" test for Section 548(a)(1)(A) claims is left standing. Under that decision, a company's intent may be established only through the "actual intent" of those individuals in a position to control the disposition of the debtor's property through their approval of the affirmative corporate act.

Since the Second Circuit's first *Tribune* decision, several courts have relied on the decision in ruling that the safe harbor shielded various transactions from avoidance because the debtor involved met the Bankruptcy Code's definition of a "financial institution" due to its use of an agent bank to effectuate a transaction. Expect many courts to continue to follow *Tribune*'s guidance in applying the Section 546(e) safe harbor to protect qualifying debtors from avoidance claims in LBOs and leveraged recapitalizations—at least until the U.S. Supreme Court decides to weigh in on the contours of the Section 546(e) safe harbor.