How The Tribune Cases Will Affect Fraudulent Transfer Claims

By **Robert Gayda, Catherine LoTempio and Andrew Matott** (May 9, 2022)

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The Tribune Co. saga finally came to a conclusion on Feb. 22 when the U.S. Supreme Court declined to review the final two pending U.S. Court of Appeals for the Second Circuit decisions to arise out of the bankruptcy cases.[1]

The Tribune cases, which commenced in 2008, enjoyed an exceptionally long life, at least by current bankruptcy standards. Although the cases appear to be over, they leave behind a lasting precedential legacy — including decisions regarding the application of the Bankruptcy Code's Section 546(e) safe harbor and the adoption of the control test for Section 548(a)(1)(A) claims in the Second Circuit.

These seminal decisions will undoubtedly play an important role in future fraudulent transfer cases.

Safe Harbor Protects Shareholders From Constructive Fraudulent Transfer Claims

The first, and perhaps most influential, concept to come out of the Tribune cases is a shareholder's ability to rely on certain safe harbors to protect itself from incurring monetary liability on constructive fraudulent transfer claims.

As part of its failed 2007 leveraged buyout, or LBO, Tribune borrowed capital secured by its assets, which it used to cash out its shareholders at a premium. After Tribune filed for bankruptcy the following year in the U.S. Bankruptcy Court for the District of Delaware, unsecured creditors sought to recover over $8 billion in shareholder payments, the transfers. These creditor lawsuits were defended in a variety of ways and became the subject of numerous appellate decisions.

In 2016, the Second Circuit issued a decision in Deutsche Bank Tr. Co. Ams. v. Large Private Beneficial Owners, or Tribune I,[2] where it held that unsecured creditors' state law constructive fraudulent transfer claims were subject to the safe harbor defense of Section 546(e). In relevant part, Section 546(e) provides that transfers by the debtor to specified financial intermediaries, such as a securities clearing agency or financial institution, that constitute transfers in connection with a securities contract are exempt from avoidance as constructively fraudulent transfers.

The Bankruptcy Code defines a financial institution to include "an entity that is a commercial or savings bank ... trust company ... and, when any such ... entity is acting as agent or custodian for a customer ... in connection with a securities contract ... such customer."[3]

The Second Circuit, in Tribune I, found that because the transfers to shareholders passed through financial intermediaries — because Tribune directed funds to a securities clearing agency or other financial institution that in turn paid the funds to shareholders in exchange for their shares that were then returned to Tribune — they were insulated from avoidance as constructive fraudulent transfers under the Section 546(e) safe harbor.

In 2018, the Supreme Court clarified in a separate case the test for determining if a transaction falls within the Section 546(e) safe harbor.[4] There, the Supreme Court ruled that a transfer is not protected by the Section 546(e) safe harbor simply because a financial institution served as a component part of a transaction, but rather held that the overarching transaction between the debtor and the intended final recipient must fall within the Section 546(e) safe harbor.[5]

However, the Supreme Court expressly left open the issue of whether a debtor/transferor itself could qualify as a financial institution by virtue of its status as a customer of a financial institution, thus still subjecting the transaction to the Section 546(e) safe harbor. In light of this ruling, two Supreme Court justices suggested that the Second Circuit reexamine its Tribune I decision.

The Second Circuit obliged, amending its decision in December 2019 in Kirschner v. Large S'holders, or Tribune II.[6] In Tribune II, the Second Circuit doubled down by reaffirming its prior conclusion that the Section 546(e) safe harbor sheltered the transfers from the unsecured creditors' state law constructive fraudulent transfer claims.

Specifically, the Second Circuit found that when Tribune transferred funds to a trust company and bank that agreed to act as a depositary to receive tendered shares and pay tendering shareholders for Tribune — it became that company's customer, pursuant to the plain meaning of the term that includes "someone who buys goods or services" as well as "a person ... for whom a bank has agreed to collect items."[7]

Moreover, the court found that the trust company plainly met the common law definition of agent because it acted on behalf of and subject to the control of Tribune. Thus, the Second Circuit ultimately held that Tribune was a financial institution based on its customer status.

Therefore, the Section 546(e) safe harbor applied and barred the underlying constructive fraudulent transfer claims. In reaching its decision, the Second Circuit relied on the broad language of Section 546(e), which it noted "protects transactions rather than firms, reflecting a purpose of enhancing the efficiency of securities markets in order to reduce the cost of capital to the American economy."[8]

Despite the Supreme Court's apparent limitation of the scope of the Section 546(e) safe harbor, the holding in Tribune II reaffirmed that constructive fraudulent transfer claims attacking LBOs and similar transactions face difficult barriers in the Second Circuit since banks or trust companies are typically utilized as agents in connection with such transactions.

Accordingly, Tribune ensures that, in the Second Circuit, public shareholders have the benefit of the Section 546(e) safe harbor on attempts to claw back payments to them under a constructive fraudulent transfer theory.

Control Test Applies to Actual Fraudulent Transfer Claims

Application of the Section 546(e) safe harbor was not the only decision favorable to shareholders to stem from Tribune. When the Delaware bankruptcy court confirmed Tribune's plan of reorganization in 2012, certain causes of action held by the estates (separate from the creditor causes of action discussed above) were channeled to a litigation trust.

The litigation trustee was empowered to pursue those causes of actions, including Section 548(a)(1)(A) claims stemming from the transfers. Section 548(a)(l)(A) permits the avoidance of any property transfer of the debtor made in the two-year window prior to a bankruptcy filing and "with an actual intent to hinder, delay or defraud" creditors.

The trustee alleged that the transfers were intentionally fraudulent conveyances because Tribune's senior management authorized those transfers with an actual intent to hinder, delay, or defraud its creditors. The difficulty with this theory was that Tribune's board of directors had created a special committee, consisting of the board's independent directors, which evaluated and recommended the LBO.

These claims were initially dismissed in January 2017. Then, in August 2021, the Second Circuit affirmed the dismissal of the trustee's intentional fraudulent conveyance claims after finding that even if Tribune's senior officers and inside directors had the requisite intent, such intent could not be imputed to the special committee.[9] In doing so, the Second Circuit applied a control test to determine whether the entity authorized to approve a transfer — here, the special committee — had the actual intent to harm creditors.

That test can be summed up as follows: "For an intentional fraudulent transfer claim, which requires 'actual intent,' a company's intent may be established only through the 'actual intent' of the individuals 'in a position to control the disposition of [the transferor's] property.'"[10] The intent of the senior officers and inside directors not on the special committee was irrelevant.

The trustee petitioned for certiorari to the Supreme Court arguing that the control test was improper and the fact that senior management had the necessary fraudulent intent was sufficient. The Supreme Court, however, declined to review the issue.

The Supreme Court's decision to deny certiorari ensured two things: The transfers made to Tribune shareholders would not be clawed back and, more notably from a practical perspective, the Second Circuit's control test for Section 548(a)(1)(A) claims will continue to apply going forward. Thus, in the wake of Tribune, the use of a special committee will make it extremely difficult for a plaintiff to prevail on actual fraudulent transfer claims.

Plaintiffs seeking to recover on fraudulent transfers in the Second Circuit when a special committee or independent director is in play must allege that the independent body was not, in its decision-making process, actually or fully independent. Such allegations may include that management pressured independent directors to approve the transfer, dominated the special committee in some fashion or that the ties between management and the independent body affected its impartiality.

Those that fail to adhere to this new pleading standard will do so at the risk of a motion to dismiss.

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[1] See Kirschner v. Large S'holders (In re Tribune Co. Fraudulent Conveyance Litig.), 10 F.4th 147 (2d Cir. 2021) (hereinafter "Tribune III"), reh'g en banc denied, No. 19-3049 (2d Cir. Oct. 7, 2021), cert. denied (Feb. 22, 2022).

[2] Deutsche Bank Tr. Co. Ams. v. Large Private Beneficial Owners (In re Tribune Co. Fraudulent Conveyance Litig.), 818 F.3d 98 (2d Cir. 2016) (hereinafter "Tribune I").

[3] 11 U.S.C. § 101(22).

[4] Merit Management Group, LP v. FTI Consulting, Inc., 138 S. Ct. 883 (2018).

[5] Id. at 893.

[6] Deutsche Bank Tr. Co. Ams. v. Large Private Ben. Owners (In re Tribune Co. Fraudulent Conveyance Litig.), 946 F.3d 66 (2d Cir. 2019) (hereinafter "Tribune II").

[7] Id. at 79.

[8] Id. at 92.

[9] Tribune III at 177.

[10] Id. at 160.