Key Issues In Potential High Court Fraudulent Transfer Case

By **Justin Ellis and Lauren Dayton** (October 23, 2020, 4:03 PM EDT)

Justin Ellis

Lauren Dayton

On Oct. 5, the U.S. Supreme Court called for the solicitor general's views on a petition for a writ of certiorari in the case Deutsche Bank Trust Co. Americas v. Robert R. McCormick Foundation et al.[1]

That petition seeks review of a decision which interpreted Section 546(e) of the Bankruptcy Code to bar constructive fraudulent transfer claims whenever a financial institution takes part in the challenged transfer.[2]

The call for the solicitor general's input makes it much more likely that the court will take up an important open question about Section 546(e)'s scope. And that question pits the goal of allowing creditors to challenge fraudulent transfers with the need to assure finality in securities transactions.

Whether or not the court grants review, the issue is well worth watching by parties and counsel contemplating either bringing or defending fraudulent transfer claims.

The Decision Below

This petition arises out of the 2007 leveraged buyout of Tribune Co. In that deal, Tribune paid over $11 billion to refinance existing debt and to buy out its existing shareholders.[3] To repurchase its stock, Tribune used a trust company and bank, Computershare Ltd.[4]

Computershare acted as depository by receiving tendered shares and paying shareholders on Tribune's behalf.[5] Because Tribune's stock was publicly traded, the shareholders involved included countless institutional investors, mutual funds and other market participants.[6]

Just under two years later, Tribune filed for Chapter 11 protection.[7] Tribune's unsecured creditors' committee then brought claims under Section 548(a)(1)(A) of the Bankruptcy Code alleging that the leveraged buyout was an intentional fraudulent conveyance.[8]

However, creditors also sought and received permission from the bankruptcy court to bring claims under state law that the leveraged buyout was a constructive fraudulent conveyance because the deal left Tribune insolvent without giving it reasonably equivalent value.[9]

The U.S District Court for the Southern District of New York initially dismissed the constructive fraud claims on standing grounds.[10]

In 2016, the U.S. Court of Appeals for the Second Circuit affirmed, but on the separate ground that Section 546(e) barred the creditors' claims.[11] That section prohibits trustees from avoiding a transfer "made by or to ... a financial institution ... in connection with a securities contract" unless the transfer is an intentional fraudulent conveyance under Section 548(a)(1)(A).[12]

The court of appeals reasoned that the leveraged buyout shareholder payment was to Computershare, a financial institution, because Computershare had acted as an intermediary.[13] As a result, the court held, the creditors could not challenge the LBO as a constructive fraudulent conveyance.[14]

While the creditors' certiorari petition was pending, the Supreme Court rejected the Second Circuit's reasoning in Merit Management Group LP v. FTI Consulting Inc.[15] In Merit, the Supreme Court held that Section 546(e) applies only if the transfer to or from a financial institution is the "overarching transfer that the trustee seeks to avoid," not merely if the financial institution acts as an intermediary.[16]

However, the court ducked what Justice Stephen Breyer described at oral argument as a "very puzzling" issue: Section 101(22)'s definition of financial institution seems to state that when a financial institution "is acting as agent or custodian for a customer ... in connection with a securities contract," then such customer is a financial institution as well.[17]

Thus, read in light of Section 101(22), Section 546(e) may shield any transfer where a financial institution acts as the transferor's agent or custodian.

Because the parties did not brief the issue, however, the court did not address it.[18]

After the Supreme Court published Merit, Justices Clarence Thomas and Anthony Kennedy issued an unusual statement stating that the Tribune petition would be deferred and that there was a possibility that the court lacked a quorum.[19] They instead suggested that the appellate court recall its mandate.[20] The Second Circuit took up that invitation and revised its opinion in December 2019.[21]

But the Second Circuit also answered the question Merit left open and found that Section 546(e) shields transactions where the transferor is the customer of a financial institution that acts as the customer's agent.[22]

Tribune was Computershare's customer, the court held, because Computershare performed services on Tribune's behalf to complete the leveraged buyout.[23] And the parties agreed that Computershare was Tribune's agent.[24] The Second Circuit thus held that 546(e) barred federal constructive fraud claims to avoid the leveraged buyout.[25]

The Second Circuit then held that Section 546(e) preempts all state law constructive fraud claims where it applies.[26] The court read Section 546(e) to "protect a national, heavily regulated market" in securities by limiting creditors' avoidance rights.[27] Without such protection, the court worried, investors could be deterred from investing in the U.S. securities market.[28]

Moreover, investors could face substantial uncertainty and cost simply from having to monitor their portfolios for suspect transactions or defending even meritless avoidance claims.[29] And, while Section 546(e) refers only to a trustee, the Second Circuit reasoned that its purposes would be undermined if private creditors could bring constructive fraudulent claims.[30]

The Second Circuit thus held that state law constructive fraud claims were preempted because they conflicted with Section 546(e)'s goals.[31]

The Tribune Petition

The creditors again petitioned for certiorari in July 2020.[32] They sought review on three questions: first, whether creditors' claims in bankruptcy are entitled to a presumption against preemption; second, whether Section 546(e) preempts state law claims; and, third, whether Section 101(22) and Section 546(e) together shield a financial institution's customers in addition to financial institutions themselves.[33]

The petition argues that the Second Circuit's use of conflict preemption in bankruptcy conflicts with the decisions of four other circuits.[34] The creditors also assert that the Second Circuit's reading of Section 546(e) is in tension with decisions from the U.S. District Court for the District of Delaware, which plays an outsize role in large Chapter 11 cases.[35]

And the court of appeals' decision, the petition urges, could "deprive Merit of any practical significance" by making almost every possible transferor that makes payments through a bank a financial institution immune from avoidance claims.[36]

The Supreme Court's call for the solicitor general's views shows that it continues to watch this issue closely. Certiorari petitions that receive a call for the views of the solicitor general are nearly 10 times as likely to be granted.[37] Review is even more likely if the solicitor general recommends it. From 2012 to 2015, for example, the Supreme Court agreed with the solicitor general's recommendations nearly 70% of the time.[38]

The government, moreover, has already expressed interest in this case, with the U.S. Securities and Exchange Commission filing an amicus brief in the Second Circuit in support of the defendants.[39] Together with the questions Justice Breyer raised in Merit about Section 546(e), these factors suggest that the court may take up the Tribune case in coming months.

Of course, this petition is hardly guaranteed to receive review. Even cases that receive a call for the views of the solicitor general still have only about a 1-in-10 chance of certiorari.[40] Moreover, as the respondents note, there is no circuit split on Section 546(e) because the Second Circuit is the first one to rule on it.[41]

And the statement by Justices Kennedy and Thomas has raised the risk that the court may lack a quorum, perhaps because, given the huge number of mutual fund defendants, almost all justices who hold mutual funds might need to recuse themselves.[42] However, the petitioners have attempted to resolve that conflict by dismissing numerous mutual funds as respondents.[43]

Implications

If the Supreme Court grants review, it will need to reconcile several conflicting principles.

As cases like Bostock v. Clayton County signal,[44] the court is increasingly inclined to enforce statutes' plain text as written — an inclination that, as Justice Breyer has noted, seems to point toward immunizing financial institutions' customers from avoidance claims.[45] The strong interest in the finality of securities transactions also weighs toward the shareholders' view.

At the same time, the Second Circuit's approach could deeply undermine creditors' rights. Because financial institutions are involved in a vast number of transactions that may leave a debtor insolvent, creditors could be unable to challenge those transactions at all unless they can prove the higher standards for an intentional fraudulent conveyance claim.

For example, the Second Circuit's approach has created counterintuitive results where companies as diverse as the shoe seller Nine West[46] and the power-generating company Boston Generating[47] are deemed financial institutions immune from constructive fraudulent transfer claims. Any ruling by the Supreme Court on this issue — or even further development in the lower courts — could shift power in one direction or another between creditors and debtors.

Given these implications, anyone who faces the possibility of prosecuting or defending fraudulent conveyance claims should watch this issue closely.

Even if the court denies review, the ongoing split between New York and Delaware — two of the country's most active bankruptcy jurisdictions — will mean that a debtor contemplating Chapter 11 or a creditor contemplating a constructive fraudulent conveyance claim will want to see how the choice of forum may affect their success in litigation.

Distressed companies assessing key financial transactions may wish to involve financial institutions heavily in their deal so as to minimize later fraudulent conveyance suits. And debtors weighing Chapter 11 may also have more incentive to file so that they can stop prebankruptcy constructive fraud claims that are pending or even threatened in other forums.

Section 546(e) will thus continue to shape strategies in distressed debt and bankruptcy litigation for the foreseeable future.

Justin M. Ellis is a partner and Lauren F. Dayton is an associate at MoloLamken LLP.

Disclosure: The authors represent Tribune Co. in unrelated litigation.

[1] Deutsche Bank Trust Co. Americas v. Robert R. McCormick Foundation, et al., No. 20-8 (U.S.).

[2] In re: Tribune Co. Fraudulent Conveyance Litig., 818 F.3d 98 (2d Cir. 2016), as amended, 946 F.3d 66 (2019).

[3] 946 F.3d at 72.

[4] Id.

[5] Id. at 78.

[6] See

[7] Petition, In re Tribune Co. et al., No. 08-13141, Dkt. 1 (Bankr. S.D.N.Y. Dec. 8, 2008).

[8] 946 F.3d at 73.

[9] Id.

[10] Id.

[11] In re: Tribune Co., 818 F.3d at 120.

[12] 11 U.S.C. §546(e).

[13] In re: Tribune Co., 818 F.3d at 120.

[14] Id.

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

[16] Id. at 893, 896.

[17] Merit Mgmt., No. 16-784, Oral Arg. Tr. at 15-16 (Nov. 6, 2017); see 11 U.S.C. §101(22).

[18] Id. at 890 n. 2.

[19] Deutsche Bank Tr. Co. Americas v. Robert R. McCormick Found., 138 S. Ct. 1162 (2018); see also Dan Epps, Quorums and conflicts of interest on the Supreme Court, SCOTUSblog(May. 7, 2018, 12:09 PM), https://www.scotusblog.com/2018/05/quorums-and-conflicts-of-interest-on-the-supreme-court/.

[20] Id.

[21] Tribune Co.. 946 F.3d at 67.

[22] Id. at 77-78.

[23] Id. at 78.

[24] Id. at 79. The Second Circuit also rejected the creditors' argument that some payments were not in connection with a "securities" contract because they involved the redemption, rather than the purchase, of shares. Id. at 80-81.

[25] Id. at 81.

[26] Id. at 90-96.

[27] Id. at 90. 94.

[28] Id. at 93.

[29] Id. at 93-94.

[30] Id. at 90.

[31] Id.

[32] Pet. For a Writ of Certiorari, Deutsche Bank Trust Co. Americas v. Robert McCormick

Foundation, No. 20-8 (July 6, 2020).

[33] Id. at (i).

[34] Id. at 18-19.

[35] Id. at 30-31.

[36] Id. at 31-32.

[37] A 2009 law review article analyzing data from 1998 through 2004 October terms found that, after a CVSG, the likelihood of cert being granted increased from 0.9% to 8.6%. David C. Thompson & Melanie F. Wachtell, An Empirical Analysis of Supreme Court Certiorari Petition Procedures: The Call For Response and The Call for The Views of The Solicitor General, 16 Geo. Mason L. Rev. 237-302 (2009), available at http://www.georgemasonlawreview.org/wp-content/uploads/2014/06/16-2_Wachtell.pdf).

[38] Ingrid Wuerth, Does the Supreme Court Follow the Recommendation of the Solicitor General in Foreign Relations Cases in which the Court has issued a CVSG?, Lawfare (March 22, 2015), https://www.lawfareblog.com/does-supreme-court-follow-recommendation-solicitor-general-foreign-relations-cases-which-court-has. This trend only appears to be increasing. For the first two and a half years of the Trump administration, the Supreme Court agreed with the SG's recommendation in 40 out of 41 cases. Adam Feldman, Comparing Cert Stage OSG Efforts Under Obama and Trump, Empirical SCOTUS (June 5, 2019), https://empiricalscotus.com/2019/06/05/cert-stage-osg/.

[39] Br. of the Sec. and Exchange Commission, In re Tribune Co. Fraudulent Conveyance Litig., No. 13-3992, Dkt. 161 (2d Cir. Mar. 6, 2014).

[40] Thompson & Wachtell, supra.

[41] Brief in Opposition, Deutsche Bank Trust Co. Americas v. Robert McCormick Foundation, No. 20-8, at 22 (Aug. 2020).

[42] Deutsche Bank Tr. Co. Americas v. Robert R. McCormick Found., 138 S. Ct. 1162, 1163 (2018); Epps, supra.

[43] Petition, supra, at 11-12.

[44] 140 S. Ct. 1731, 1738 (2020)

[45] See Tr. of Oral Arg., supra.

[46] In re: Nine W. LBO Sec. Litig., No. 20 Misc. 2941, 2020 WL 5049621, at *11 (S.D.N.Y. Aug. 27, 2020).

[47] In re: Bos. Generating LLC, 617 B.R. 442, 487 (Bankr. S.D.N.Y. 2020).