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Second Circuit Court of Appeals Partially Resuscitates Tribune Leveraged Buyout Litigation

By Benjamin Mintz and Justin Imperato*

The authors of this article discuss another decision by the U.S. Court of Appeals for the Second Circuit in the Tribune Company Fraudulent Transfer Litigation.

The U.S. Court of Appeals for the Second Circuit has issued another decision in the Tribune Company Fraudulent Transfer Litigation,[1] partially upholding the U.S. District Court for the Southern District of New York's dismissal of certain claims filed against the Tribune Company's ("Tribune") shareholders stemming from Tribune's buy-back of outstanding shares pursuant to a 2007 leveraged buy-out transaction ("LBO") to go public and the financial firms that advised Tribune in connection with the LBO.

Of note, the Second Circuit:

(1) Held that Tribune's LBO structured in two steps should not be collapsed into a single transaction for purposes of analyzing the claims asserted by the bankruptcy litigation trustee ("Trustee");

(2) Held that factual questions existed as to whether two financial advisory firms provided "reasonably equivalent value" for their "success fees" in connection with the Trustee's constructive fraudulent transfer claims against such firms;

(3) Adopted the "control" test to determine whether a company's officers'intent to defraud creditors could be imputed to an independent special committee for purposes of analyzing intentional fraudulent transfer claims asserted by the Trustee against shareholders; and

(4) Denied the Trustee leave to add a constructive fraudulent transfer claim against shareholders on the basis of futility in light of the Bankruptcy Code's safe harbor and the Second Circuit's *Tribune II* (as defined below) decision.

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* Benjamin Mintz is a partner at Arnold & Porter Kaye Scholer LLP practicing in the restructuring and bankruptcy area with extensive transactional and litigation experience. Justin Imperato is an associate at the firm practicing in all areas of corporate restructuring, bankruptcy, and insolvency-related matters. The authors may be reached at benjamin.mintz@arnoldporter.com and justin.imperato@arnoldporter.com, respectively.

[1] *See In re Tribune Co. Fraudulent Transfer Litig.*, Docket Nos. 19-3049-cv; 19-449-cv (2d Cir. Aug. 20, 2021).

RELEVANT FACTUAL BACKGROUND

Tribune Retained Financial Advisors

Prior to the LBO in 2007 and as a result of the media industry's changing landscape in the digital age, Tribune's board of directors ("Board") formed a special committee ("Special Committee") to address potential ways to return value to Tribune's shareholders. In October 2005, prior to formation of the Special Committee, the Board hired Citigroup Global Market, Inc. ("Citigroup") and Merrill, Lynch, Pierce, Fenner, and Smith, Inc. ("Merrill Lynch") as financial advisors to analyze and propose possible responses to the ongoing changes in the media industry. Merrill Lynch and Citigroup each signed engagement letters that promised each a "Success Fee" of $12.5 million if a "Strategic Transaction" was completed.

The LBO's Structure

Before execution, the Special Committee consulted several large shareholders holding approximately 33 percent of Tribune's shares ("Large Shareholders") in connection with the proposed LBO. Concerned Tribune's share price would drop before the Large Shareholders could sell their shares, the Large Shareholders informed the Special Committee that they would only vote for a two-step LBO that allowed them to cash out during step one regardless of whether step two subsequently occurred. Ultimately, in consultation with Merrill Lynch and Citigroup, the Board approved a two-step LBO transaction. In step one, Tribune borrowed money to buy back roughly half of its shares ("Step One"). In step two, Tribune would borrow more money to purchase all remaining shares outstanding ("Step Two"). Step One contemplated the possibility that Step Two might not occur.

The LBO's Implementation

On April 11, 2007, Tribune retained Valuation Research Company ("VRC") to provide two solvency opinions for the LBO, one for Step One and the other for Step Two. On May 24, 2007, VRC issued an opinion that Tribune would be solvent after completing Step One. According to the Trustee, however, after VRC issued this solvency opinion, Tribune's management learned that the financial projections, upon which VRC's solvency opinion was based, were no longer an accurate forecast of Tribune's 2007 second half performance.

According to the Trustee, no one alerted VRC that Tribune was unlikely to meet its 2007 second-half financial projections. In fact, the Trustee alleged that Citigroup and Merrill Lynch reviewed VRC's solvency analysis but "failed to fulfill their responsibilities as "gatekeepers" retained to objectively analyze the LBO."

In spite of these issues, Tribune delivered VRC's solvency opinion for Step One to the financing banks on June 4, 2007. Step One closed the same day and thereafter, Tribune borrowed $7 billion to pay off its existing bank debt and to complete a tender offer, buying back just over half of its publicly held shares. The Large Shareholders sold all their shares, and the members of the Board appointed by those Large Shareholders resigned.

The LBO's Aftermath

On December 20, 2007, Step Two closed. Thereafter, Tribune borrowed an additional $3.7 billion, which it used to buy-back its remaining publicly held shares. After Step Two closed, (i) Tribune had roughly $13 billion in debt; (ii) Tribune's directors and officers received approximately $107 million from selling their stock and from bonuses; and (iii) Citigroup and Merrill Lynch were each paid their $12.5 million success fee because they helped effectuate a "Strategic Transaction."

THE SECOND CIRCUIT'S DECISION

Two-Step LBO Should Not Be Collapsed into One Transaction

By way of background, under Delaware law, a shareholder owes the company a fiduciary duty "only if it owns a majority interest in or exercises control over the business affairs of the corporation."[2] If fiduciary duties are owed by a shareholder, such shareholder breaches that duty if, for its own benefit, it approves a transaction that renders the corporation insolvent.[3]

The Trustee asserted Delaware state law breach of fiduciary duty claims against the Large Shareholders (which the Large Shareholders sought to dismiss) alleging, among other things, that the Large Shareholders breached their fiduciary duties by pushing for the LBO based on financial projections they knew to be false and by causing Tribune to incur debt they knew would render Tribune insolvent. While Tribune may have been rendered insolvent as a result of Step Two, it is less clear whether Tribune was insolvent at or from Step One.

In the district court, the Trustee sought to collapse Steps One and Two into a single transaction so that the Large Shareholders could be sued for their conduct. In other words, because it appeared less likely Tribune was rendered insolvent from Step One, the Trustee could not adequately plead his breach of

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[2] *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987).

[3] *See, e.g.*, *In re Tropicana Entm't, LLC*, 520 B.R. 455, 471 (Bankr. D. Del. 2014) (holding that a creditor must allege either that a corporation was or became insolvent as a result of the fiduciary's misconduct to bring suit for breach of fiduciary duty).

fiduciary duty claims under Delaware state law. Further, while the Trustee adequately plead Tribune's insolvency at Step Two, the fiduciary duty claims nevertheless failed because, after Step One, the Large Shareholders no longer owned Tribune's stock, i.e., they no longer owed fiduciary duties to Tribune, and had relinquished their seats on the Board.

The district court dismissed the Trustee's breach of fiduciary duty claims, holding that Steps One and Two could not be collapsed and that Tribune's purported insolvency had to be analyzed separately at each step of the LBO. On appeal, the Trustee argued that the District Court incorrectly refused to collapse the LBO's two steps and, alternatively, that he adequately plead that Tribune was insolvent at Step One. The Second Circuit disagreed holding that: (i) the Trustee failed to sufficiently allege that Tribune was insolvent at Step One under either the "balance sheet" or "inability to pay debts when due" tests, and (ii) the LBO transaction steps could not be collapsed under either the *Sabine* test,[4] which applies federally, or Delaware's "step-transaction doctrine."[5]

Without deciding the appropriate test to apply in this instance, the Second Circuit held that collapse was inappropriate under: (i) *Sabine*, as *Sabine*'s third-factor weighed against collapse, i.e., Step Two was not conditioned or dependent on Step One, and (ii) any of the three tests included in Delaware's "step-transaction doctrine" because "the parties intended to structure the two steps as independent transactions, Step One was able to stand alone, and there was no binding commitment to undertake Step Two."

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[4] *See Sabine Oil & Gas Corp.*, 547 B.R. 503, 541 (Bankr. S.D.N.Y.), *aff'd*, 562 B.R. 211 (S.D.N.Y. 2016) (holding that to determine whether to collapse two steps of a transaction into one, courts should consider (i) "[w]hether all of the parties involved had knowledge of the multiple transactions"; (ii) "[w]hether each transaction would have occurred on its own"; and (iii) "[w]hether each transaction was dependent or conditioned on other transactions.").

[5] Under this doctrine, collapse is warranted if a party can satisfy any one of three tests, which tests include: (1) the "end result test," which authorizes collapse "if it appears that a series of separate transactions were prearranged parts of what was a single transaction, cast from the outset to achieve the ultimate result"; (2) the "interdependence test," which authorizes collapse if "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series"; and (3) the "binding-commitment test," which allows collapse "only if, at the time the first step is entered into, there was a binding commitment to undertake the later steps." *Bank of N.Y. Mellon Tr. Co. v. Liberty Media Corp.*, 29 A.3d 225, 240 (Del. 2011) (internal quotation marks omitted).

QUESTIONS EXIST AS TO WHETHER CITIGROUP AND MERRILL LYNCH PROVIDED REASONABLY EQUIVALENT VALUE FOR THE SUCCESS FEES

The Trustee sued Merrill Lynch and Citigroup alleging constructive fraudulent transfer claims against the financial advisory firms in connection with each firm's receipt of a "success fee" following consummation of the LBO. The district court dismissed the Trustee's constructive fraudulent transfer claims against Merrill Lynch and Citigroup but the Second Circuit reversed.

Generally speaking, Bankruptcy Code Section 548(a)(1)(B) authorizes a trustee to claw back transfers made by a debtor within two-years of the bankruptcy petition date for which the debtor received less than "reasonably equivalent value."[6]

On appeal, the Second Circuit considered whether the district court erred in dismissing the Trustee's constructive fraudulent transfer claims to claw back the "success fees." The Second Circuit held that, "[w]hile it is a close call, because we are required to accept the allegations in the Trustee's complaint as true, we conclude the factual question of whether Citigroup and Merrill Lynch provided reasonably equivalent value for their success fees cannot be decided without first assessing whether the banks satisfactorily performed their duties. Thus, dismissal of the constructive fraudulent conveyance claims against these parties was premature."[7]

In contrast, with respect to the other financial advisory firms that Tribune retained to navigate and complete the LBO, the Second Circuit held that the Trustee's constructive fraudulent transfer claims were appropriately dismissed where both VRC and Morgan Stanley, among other things, "did not have the same incentives as Citigroup and Merrill Lynch[,] . . . earned their respective fees upon delivery of their contracted-for opinions[,] . . . had no financial stake in the LBO's consummation[,] . . . [received] payments . . . before Step One closed[,] and . . . there [wa]s hardly an allegation that Tribune was insolvent before the first step . . . ." In other words, VRC and Morgan Stanley

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[6] *See* 11 U.S.C. § 548(a)(1)(B).

[7] The district court dismissed constructive fraudulent transfer claims against Merrill Lynch and Citigroup finding that the debt was incurred when Citigroup's and Merrill Lynch's engagement letters were signed, years before the LBO's completion, thus rendering the "success fees" that the Trustee sought to claw back as unavoidable antecedent debt. In contrast, the Second Circuit held that Citigroup's and Merrill Lynch's "success fees" were not debts incurred or owed until December 2007 (when the LBO closed at Step Two) and thus were not antecedent debt constituting reasonably equivalent value.

appear to have been insulated from the Trustee's constructive fraudulent transfer claims based, in large part, on the fact that their fees weren't tied to consummation of the LBO and were due before Tribune was insolvent.

SECOND CIRCUIT ADOPTS "CONTROL TEST"

The Trustee sued shareholders alleging intentional fraudulent transfer claims in connection with the shareholders' buy-back of their shares. According to the Trustee, Tribune's management possessed actual intent to defraud Tribune's creditors in connection with the buy-back and such intent could be imputed to the Special Committee, thus permitting claw back of the monies paid by Tribune to its shareholders. Bankruptcy Code Section 548(a)(1)(A) authorizes a trustee to claw back transfers made by a debtor within two years of the bankruptcy petition date where the debtor made such transfer "with actual intent to hinder, delay, or defraud" its creditors.[8]

The Second Circuit recognized that, under Delaware law, only the board of directors (or a committee to which the board has delegated its authority) has the power to approve an extraordinary transaction, such as the LBO. Here, the Board delegated its authority to approve the LBO to the Special Committee. Thus, according to the Second Circuit, the Trustee was required to allege that the Special Committee had the "actual intent to hinder, delay, or defraud" Tribune's creditors. The Trustee did not assert that the Special Committee's members had "actual intent" to harm Tribune's creditors. Instead, the Trustee asserted that Tribune's senior management had the necessary fraudulent intent, and that this intent must be imputed to the Special Committee.

The Second Circuit held that the issue of whether a company's officers' intent to defraud creditors could be imputed to an independent special committee for purposes of a fraudulent transfer claim was a question of first impression in the Second Circuit. Relying on the First Circuit's "control test," the Second Circuit held that for an intentional fraudulent transfer claim, 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" and concluded that the Trustee failed to plausibly allege that the intent of Tribune's senior management should be imputed to the Special Committee, i.e., the Trustee failed to allege that Tribune's senior management controlled the Special Committee's decision-making or the transfer of the property in question.

As a result, the Second Circuit affirmed the district court's dismissal of these claims.

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[8] 11 U.S.C. § 548(a)(1)(A).

TRUSTEE'S REQUEST FOR LEAVE TO AMEND COMPLAINT IS DENIED

Solely with respect to claims against the shareholders, the Trustee sought leave from the district court to amend his complaint to add constructive fraudulent transfer claims. The District Court denied the Trustee's request holding that, (i) if the amendment were permitted, the shareholders would suffer substantial prejudice and (ii) the proposed addition of constructive fraudulent transfer claims would be futile. The Second Circuit affirmed the district court's denial of the Trustee's request for leave to amend and expounded on why permitting such an amendment would be futile.

Under the Bankruptcy Code, certain transactions fall within a safe harbor and thus cannot be clawed back via a constructive fraudulent transfer claim.[9] The safe harbor protects payments made "in connection with a securities contract" if that payment was made by "a financial institution."[10] In another decision issued by the Second Circuit in the Tribune Company Fraudulent Transfer Litigation, the Second Circuit held that Tribune's payments to its shareholders fell within this safe harbor.[11]

On appeal here, the Trustee argued that the district court and the *Tribune II* panel improperly concluded, among other things, that Tribune was a financial institution and that the safe harbor applied. The Second Circuit disagreed and held that permitting the Trustee to amend his complaint to add a constructive fraudulent transfer claim would be futile because such transfers would be protected by the safe harbor.

CASE UPDATE

On October 7, 2021, an en banc panel for the Second Circuit issued an order denying the Trustee's petition for a panel rehearing or a rehearing en banc of the court's August 20, 2021, decision. The Trustee may still seek further review by the U.S. Supreme Court.

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[9] *See* 11 U.S.C. §§ 544, 546(e).

[10] *Id.* § 546(e).

[11] *See In re Tribune Company Fraudulent Transfer Litig.*, 946 F.3d 66, 77–81, 90–97 (2d Cir. 2019) ("*Tribune II*") (holding that Tribune was a "financial institution" within meaning of safe harbor provision and that payments to shareholders were payments "in connection with a securities contract").