Second Circuit Fumbles Tribune on Reconsideration

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The Second Circuit recently issued its revised opinion in *Tribune Company Fraudulent Conveyance Litigation*, Case No. 13-3992-cv(L), as amended (2d Cir. Dec. 19, 2019) following the suggestion of Justices Kennedy and Thomas, 2018 WL 1600841 (Apr. 3, 2018) (on certiorari Case No. 16-317), to reconsider its prior ruling, 818 F.3d 98 (2d Cir. 2016), while certiorari continues to pend. In a remarkable twist salvaging the result of its prior decision notwithstanding the intervening Supreme Court decision in *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, 138 S.Ct. 883 (2018), overruling the Second Circuit caselaw it had previously relied upon, the Second Circuit determined that a debtor-transferor that effectuates a transfer involving a securities contract in its capacity as the customer of a commercial bank is itself a “financial institution” within the meaning of the Bankruptcy Code section 101(22)(A) and therefore the transfer is protected under section 546(e).

In a petition for rehearing en banc, appellants point out material factual and procedural errors in the Second Circuit opinion. *Tribune Company Fraudulent Conveyance Litigation*, Case No. 13-3992-cv(L) (Dkt. No. 435 filed Jan. 2, 2020). But the Second Circuit’s systemically threatening errors here are substantive and legal, not procedural and factual.

It is, of course, simply bizarre to define the statutory term “financial institution” to include all commercial bank customers. No ordinary definition of “financial institution” would designate all commercial bank customers as themselves financial institutions. Bank customers are customers because they need the services of a financial institution precisely because they are not financial institutions themselves.

More importantly, this ruling has critically important implications for the avoiding powers of the bankruptcy trustee. Section 546(e) insulates all transfers by or to a financial institution from avoidance except as an “actual fraud” under section 548(a)(1)(A). Virtually all transferors are customers of commercial banks and almost any transfer can be effectuated with funds transferred through the agency or in the possession of a commercial bank. The result is the virtual repeal of the avoiding powers as to any transfer involving securities that is not an actual fraud on creditors, undoing centuries of fraudulent transfer and preference law.

These considerations are powerful enough that the Second Circuit, if necessary in light of the plain language of the statute, should have striven mightily to avoid interpreting the term “financial institution” in section 101(22)(A) so as to include the customers of commercial banks. The Code’s avoiding power sections read as a whole make no sense if limited only to cases involving transfers by financial institutions.

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1 Although he has no continuing involvement in the case, my law partner and former UCLA colleague, Kenneth N. Klee, was the court-appointed examiner in the underlying *Tribune Company* bankruptcy case in the United States Bankruptcy Court for the District of Delaware. Our law firm, KTBS Law LLP, served as counsel to Mr. Klee during the bankruptcy case, but I had no personal involvement in the matter. The views expressed here are mine alone and do not reflect those of Mr. Klee, KTBS Law LLP, or any of its clients.
entities that are not customers of commercial banks. Moreover, such a reading of section 101(22) flies in the face of Merit Management, the recent, directly applicable, Supreme Court precedent.

But no striving is necessary to meet the demands of common sense, policy and precedent, if one carefully parses the language of section 101(22)(A) itself. That section reads:

(22)The term “financial institution” means—

(A) a Federal reserve bank, or an entity that is a commercial or savings bank, industrial savings bank, savings and loan association, trust company, federally-insured credit union, or receiver, liquidating agent, or conservator for such entity and, when any such Federal reserve bank, receiver, liquidating agent, conservator or entity 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.

The literal language of this section only makes a customer of a Federal reserve bank, receiver, liquidating agent or conservator a “financial institution” if the customer acts through such entity. Although commercial banks themselves are defined as “financial institutions,” their customers, on the face of the statute itself are pointedly excluded by the statute’s language.

This plain reading of the statute is obscured by the Second Circuit through its liberal use of ellipses in quoting the statute to make it seem consistent with the court’s holding. The Second Circuit mischaracterized the statute as reading:

Section 101(22) of the Code defines “financial institution,” to include, inter alia, “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 (whether or not a “customer,” as defined in section 741) in connection with a securities contract (as defined in section 741) such customer.” 11 U.S.C. § 101(22)(A) (emphasis added). Tribune, slip op. at 23-24.

The un-ellided statute, Supreme Court precedent, and policy, all work together to exclude the customers of commercial banks from the safe harbor of section 546(e).

The Second Circuit only read the statute differently by collapsing through ellipses the first and second clauses of section 101(22)(A) to make it seem as if the statutory reference to commercial banks acting in their own behalf also applied when they acted on behalf of their customers. But the clause of section 101(22)(A) that protects customers only applies to customers of Federal reserve banks, receivers, liquidating agents and conservators—a very limited group of persons—not customers of a “commercial or savings bank, industrial savings bank, savings and loan association, trust company, federally-insured credit union”—a class that includes virtually every conceivable transferor.

Accordingly, the Second Circuit’s recent Tribune opinion is not only wrong on policy and precedent bases, but it is also premised on a mischaracterization of the statutory language.
Unfortunately, the seed of the Second Circuit’s error lies in the Supreme Court’s decision not to address the scope of the customer exception in section 101(22) in *Merit Management*. See 138 S. Ct. 883, 890 at n.2 (2018) (“The parties here do not contend that either the debtor or petitioner in this case qualified as a "financial institution" by virtue of its status as a "customer" under § 101(22)(A). Petitioner Merit Management Group, LP, discussed this definition only in footnotes and did not argue that it somehow dictates the outcome in this case. See Brief for Petitioner 45, n. 14; Reply Brief 14, n. 6. We therefore do not address what impact, if any, § 101(22)(A) would have in the application of the § 546(e) safe harbor.”) Even though the issue had been waived by the parties, having chosen to allude to it in footnote 2, Justice Sotomayor would have done the bankruptcy system, and the cause of careful statutory interpretation, a great service by also noting that it appeared that customers of commercial banks like the parties in *Merit Management* itself appeared to fall outside the literal language of section 101(22)(A).

As noted above a petition for rehearing en banc is now pending in the Second Circuit while certiorari continues to pend in the Supreme Court. One can only hope that the court of appeals will overcome its historic reluctance to grant rehearing en banc to correct the serious errors made by the panel, or that the Supreme Court can muster a quorum to grant certiorari and repair the damage done below.