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Supreme Court Holds That Presence of Financial Conduits Does Not Trigger "Safe Harbor" Protection for Securities-Related Transfers Under Section 546(e) of the Bankruptcy Code

On February 27, 2018, the United States Supreme Court resolved a circuit split regarding the proper application of the safe harbor set forth in section 546(e) of the Bankruptcy Code, a provision that prohibits the avoidance of a transfer if the transfer was made in connection with a securities contract and made by or to (or for the benefit of) certain qualified entities, including a financial institution. In a unanimous decision, the Court held that transfers in connection with a share purchase agreement between two non-financial institutions was not safe-harbored under section 546(e) solely because the transaction was effectuated via transfers between financial institutions. *Merit Mgmt. Grp., LP* v. *FTI Consulting, Inc.*, No. 16-784, 283 U.S. ___ (2018), 2018 WL 1054879, at *12 (Feb. 27, 2018). Rather, the Supreme Court held that section 546(e) only protects the "overarching" transfer that the trustee seeks to avoid, and the presence of financial institutions operating as conduits does not trigger application of the securities safe harbor. In affirming a ruling from the United States Court of Appeals for the Seventh Circuit, the Supreme Court effectively rejected broader interpretations of section 546(e) adopted by numerous other circuit courts, including the Second Circuit, which held that the presence of a financial institution as a conduit protected the overall transfer from avoidance.

Background and Lower Court Decisions

Valley View Downs, LP ("Valley View") and Bedford Downs Management Corporation ("Bedford Downs") were competing for the last available harness-racing license in Pennsylvania. Ultimately, rather than compete for the license, Valley View and Bedford Downs entered into an agreement providing that Bedford Downs would no longer pursue the license and Valley View would purchase all of Bedford Downs' stock for $55 million after Valley View obtained the license.

Valley View obtained the license and moved forward with the stock purchase transaction. Valley View arranged for the Cayman Islands Branch of Credit Suisse ("Credit Suisse") to finance the purchase price. Credit Suisse wired $55 million to Citizens Bank of Pennsylvania ("Citizens Bank"), which acted as the third-party escrow agent for the transaction. Bedford Downs' shareholders, including Merit Management Group, LP ("Merit"), deposited their stock certificates into escrow with Citizens Bank. When the transaction closed, Valley View received Bedford Downs' stock certificates and Citizens Bank disbursed cash to the Bedford Downs shareholders. Merit received approximately $16.5 million from the sale.

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Valley View and its parent company, Centaur, LLC, subsequently commenced chapter 11 cases, and the Bankruptcy Court confirmed a plan of reorganization. Under the plan, FTI Consulting, Inc. ("FTI") was appointed as trustee of a litigation trust to pursue causes of action for the benefit of Valley View's creditors.

In 2015, FTI commenced an action against Merit seeking to avoid the $16.5 million transfer from Valley View to Merit as a constructive fraudulent transfer under section 548 of the Bankruptcy Code.[1] Valley View moved for judgment on the pleadings, arguing that the Valley View-to-Merit transfer was safe-harbored under section 546(e) because the transfer (i) was a "settlement payment" or otherwise a transfer made "in connection with a securities contract," and (ii) was made "by or to (or for the benefit of)" a covered "financial institution," namely, Credit Suisse and Citizens Bank.[2]

The District Court granted the motion, finding that the transfer was safe-harbored under section 546(e) because the financial institutions (Credit Suisse and Citizens Bank) transferred or received funds in connection with a "settlement payment" or "securities contact." The Seventh Circuit reversed, holding that section 546(e) did not apply to transfers in which financial institutions served as mere conduits. The Supreme Court granted certiorari to resolve a circuit split regarding the proper application of the securities safe harbor.

Supreme Court Decision

The Court began by noting that the parties' and the lower courts' analyses focused on (i) the phrase "by or to (or for the benefit of)" as used in section 546(e), and (ii) the question of whether a "financial institution" or other covered entity must have a beneficial interest in or dominion and control over transferred property to qualify for safe harbor protection. The Supreme Court stated that these "issues put the proverbial cart before the horse[,]" because a court must first identify the relevant "transfer" before engaging in an analysis of whether that transfer falls within the parameters of the safe harbor.[3]

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1 FTI maintained that Valley View (a) was insolvent when it purchased Bedford Downs' stock and (b) "significantly overpaid" for it.

2 Section 546(e) of the Bankruptcy Code provides in pertinent part that: "Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a . . . settlement payment . . . made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract . . . that is made before the commencement of the case, except under section 548(a)(1)(A) of this title."

3 In a footnote, the Supreme Court noted that "[t]he parties do not ask this Court to determine whether the transaction at issues in this case qualifies as a transfer that is a 'settlement payment' or made in connection with a 'securities contract' as those terms

The Court found that the relevant transfer for purposes of section 546(e) is the "overarching" transfer that the trustee seeks to avoid. Because FTI sought to avoid the transfer from Valley View to Merit, the Supreme Court reasoned that the payment from Valley View to Merit was the "transfer" that should be analyzed for purposes of section 546(e). The Supreme Court explained that its construction of the safe harbor was supported by the text of section 546(e) and by the overall structure of the Bankruptcy Code, each of which provides that section 546(e) operates as an *exception* to avoidance powers arising under other provisions of the Bankruptcy Code. The Court noted that, logically, these were "two sides of the same coin," because the avoidance powers permit a trustee to avoid certain transfers, while the safe harbors provide exceptions to that power. Accordingly, the safe harbor must apply to the same transfer that the trustee seeks to avoid.

The Supreme Court found that the component parts of the overarching Valley View-to-Merit transaction—the transfer of funds from Credit Suisse to Citizens Bank and the transfer of those funds from Citizens Bank to Bedford Downs' shareholders—were "simply irrelevant to the analysis under § 546(e)." The Court explained that:

> after a trustee files an avoidance action identifying the transfer it seeks to set aside, a defendant in that action is free to argue that the trustee failed to properly identify an avoidable transfer under the Code, including any available arguments concerning the role of component parts of the transfer. If a trustee properly identifies an avoidable transfer, however, the court has no reason to examine the relevance of component parts when considering a limit to the avoiding power, where that limit is defined by reference to an otherwise avoidable transfer, as is the case with §546(e). . . .

The Supreme Court noted that Merit did not argue that FTI improperly identified the Valley View-to-Merit transfer as the relevant transfer for avoidance purposes but instead focused on whether FTI could ignore the component parts for safe-harbor purposes. Accordingly, the focus of the section 546(e) inquiry must remain on the transfer that FTI sought to avoid.

The Supreme Court addressed and rejected certain arguments advanced by Merit to support its assertion that section 546(e) bars avoidance of a transfer if the overarching transfer *or any component transaction* satisfies the safe-harbor criteria, including Merit's interpretation of a 2006 amendment to section 546(e).

The Court also rejected Merit's argument that the safe harbor must be read to protect intermediaries without reference to any beneficial interest in the transfer because a "securities clearing agency" is a covered entity under the safe harbor and by definition "is an intermediary in payments or deliverables made in connection with securities transactions[.]" The Court noted that (i) the issue of whether a

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are used in § 546(e), nor is that determination necessary for resolution of the question present." *Merit Mgmt. Grp., LP* v. *FTI Consulting, Inc.*, 2018 WL 1054879, at *7 n.5.

securities clearing agency always acts as an intermediary without a beneficial interest in the transaction is an open question, and (ii) the proper analysis must focus on whether the subject "transfer was 'made by or to (or for the benefit of)' a covered entity, including a securities clearing agency."

The Supreme Court next addressed Merit's assertion that "the broad language of section 546(e) shows that Congress took a 'comprehensive approach to securities and commodities transactions' that 'was prophylactic, not surgical,' and meant to 'advance the interests of parties in the finality of transactions.'" The Court dismissed this argument too, noting that the plain language of the safe harbors expressly protects transfers made "by or to" covered entities, and not transfers made "through" a covered entity.

Having disposed of Merit's arguments, the Supreme Court considered whether the Valley View-to-Merit transfer, without taking into account the intermediate transfers involving Credit Suisse and Citizens Bank, qualified for protection under section 546(e). The Court noted that the parties did not contend that either Valley View or Merit was a "financial institution" or a covered party under section 546(e) and therefore concluded that the Valley View-to-Merit transfer fell outside of the safe harbor and FTI was not barred from seeking to avoid it.

Conclusion

The Supreme Court's decision in *Merit Management Group* provides clarity regarding the proper interpretation of section 546(e) of the Bankruptcy Code and resolves a conflict among circuit courts regarding its application. The extent to which the decision may have ripple effects in pending avoidance and safe harbor litigation, including those addressing failed leverage buyouts, or unintended consequences in cases involving transactions more complex than the straightforward stock purchase transaction at issue in *Merit Management Group*, remains to be seen.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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