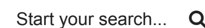

Supreme Court Limits the Scope of Safe Harbor Protection in Avoidance Actions

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On February 27, 2018, the Supreme Court resolved a split between the Second, Third, Sixth, Eighth, and Tenth Circuit, and the Seventh and Eleventh Circuit in its ruling in *Merit Management Group, L.P. v. FTI Consulting, Inc. (“Merit Management”)* 583 U. S. ____ (U.S. Feb. 27, 2018). The Supreme Court sided with the Seventh and Eleventh Circuit, holding that the presence of a “financial institution” in a multi-step transfer is insufficient to invoke a Bankruptcy Code safe harbor if the financial institution is a mere conduit (i.e. if the financial institution does not have an interest in the transferred property). The safe harbor at issue, Bankruptcy Code Section 546(e), prohibits the trustee from avoiding certain transfers made by, to or for the benefit of a list of enumerated financial market participants.[1]

Background

In *Merit Management*, Valley View Downs, LP, (“Valley View”) and Bedford Downs Management Corp. (“Bedford”) entered into an agreement where Valley View agreed to acquire all of the shares of Bedford for $55 million as part of larger transaction. Two banks served as intermediaries in the transaction, wiring and disbursing the money from Valley View to Bedford’s shareholders, including Bedford’s largest shareholder, Merit Management (“Merit”). Additionally, one of the banks held an escrow that served as security for Bedford’s post-closing indemnity obligation to Valley View.

Valley View and its parent later filed for chapter 11 bankruptcy. After plan confirmation, the post-confirmation litigation trustee sued Merit seeking to recover $16.5 million that Merit received in exchange for its shares as a constructive fraudulent transfer. The trustee alleged that Valley View was insolvent at the time it paid for the Bedford shares, and that Valley View had significantly overpaid for those shares.

Merit sought dismissal of the lawsuit, arguing that the trustee was barred from avoiding the transfer because of the safe harbor protections of Section 546(e). The District Court agreed with Merit and dismissed the case, reasoning that the transfer was a settlement payment made by or to the type of financial institution covered by the safe harbor–namely, the two banks that handled the payments made to the Bedford shareholders. On appeal, the Seventh Circuit reversed the District Court’s decision, holding that Section 546(e) does not protect transfers when the financial institution acts as a “mere conduit” in the transaction.

Supreme Court Ruling

In a unanimous ruling, the Supreme Court agreed with the Seventh Circuit’s interpretation of Section 546(e). Though the parties disagreed whether the words “by or to (or for the benefit of)” required the financial institution to have a beneficial interest in the transfer, the Court stated that these inquiries “put the proverbial cart before the horse.” See *Merit Management*, 583 U. S. ____, at 10. Instead, the relevant focus for purposes of a safe harbor analysis is on the specific transfer that the trustee seeks to avoid (in *Merit Management*, the $16.5 million payment from Valley View to Merit, not any flow of funds from Valley View to either bank). *See id*. The Court determined that a narrow reading of Section 546(e) is supported by the statute’s text, context, and focus on the substantive nature of the transfer, as well as parallel language in other sections of the Bankruptcy Code. Merit also argued that the parenthetical “(or for the benefit of)” was used in a disjunctive sense to mean that the financial institution did not need to have a beneficial interest in the transfer to trigger the safe harbor. The Court rejected this argument, construing “(or for the benefit of)” as another way to protect a covered entity from avoidance, which did not extend to intermediaries lacking a beneficial interest in the transfer. *See id.* at 16. (stating that “a trustee seeking to avoid a preferential transfer under that creditor is a covered entity under § 546(e)…cannot now escape application of the § 546(e) safe harbor just because the transfer was not ‘made by or to’ that entity.”).

Notably, the Court declined to consider the statutory purpose for Section 546(e) in making its decision. *See id*. at 18. The Court rejected Merit’s argument that Section 546(e) was meant to be a

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"prophylactic" measure to protect the securities markets from the disruptive risk of avoidance liability, stating that such an argument was "nothing more than an attack on the text of the statute," and that the plain meaning of Section 546(e) protected the transfers that Congress intended to protect. *See id*. at 18. The Court's reasoning directly contrasts with that of courts like the Second Circuit, which have emphasized that in crafting Section 546(e), Congress intended to shield securities markets from the unwinding of securities transactions. In *In re Tribune Co. Fraudulent Conveyance Litigation*, the Second Circuit held that Section 546(e) protected transfers made to shareholders of a public company, reasoning that that the legislative history and broad language of Section 546(e) compel such a result:

> Section 546(e)'s protection of the transactions consummated through these intermediaries… was sought by the SEC—and corresponding provisions by the CFTC....to protect investors from the disruptive effect of after-the-fact unwinding of securities transactions… A lack of protection against the unwinding of securities transactions would create substantial deterrents, limited only by the copious imaginations of able lawyers, to investing in the securities market. The effect of appellants' legal theory would be akin to the effect of eliminating the limited liability of investors for the debts of a corporation: a reduction of capital available to American securities markets.

See In re Tribune Co. Fraudulent Conveyance Litigation, 818 F.3d 98, 121 (2d Cir. 2016).

Due to the fact that the parties did not contend that either Valley View (the transferor) or Merit (the transferee) is a covered entity described in Section 546(e), the Court concluded that the transfer was not protected by the safe harbor. *See id*. at 19. The Court affirmed the Seventh Circuit and remanded the case for proceedings consistent with the Court's ruling.

Takeaways

It is difficult to predict the impact of *Merit Management*, because the court's analysis will require to a fact-dependent inquiry to determine whether a challenged transfer is protected under Section 546 (e). However, the opinion raises some issues for litigants to consider:

- The threshold issue in a Section 546(e) inquiry is whether the ultimate transfer meets the safe-harbor requirements. Using the Court's example, in examining the chain of events in a transfer that was executed through intermediaries B and C, such that the transfer is A → B → C → D, the relevant transfer is A → D. *See id*. at 1. The fact that B and C are "financial institutions" or other qualified entities under Section 546(e) is irrelevant if B and C are mere conduits in connection with the transfer.

- *Merit Management*'s impact in circumstances outside of the fact pattern the Court considered, which involved a relatively simple stock transaction structure between two private parties, is unclear. For instance, it is unclear how a court would approach a transfer-by-transfer Section 546(e) analysis with respect to transfers to individual shareholders of a public company. However, in *Merit Management*, the Court specifically rejected a safe harbor argument that was premised upon potential market disruption.

- The Section 546(e) analysis requires a factual inquiry for each defendant. In the future defendants may make additional arguments regarding their status as an entity qualified for the protection of Section 546(e). Interestingly, as the Supreme Court recognized, neither party in *Merit Management* briefed whether Valley View or Merit (as opposed to the intermediary banks) fell under the statutory definition of "financial institution" by virtue of their potential status as a "customer" of a financial institution (as contemplated by the relevant Bankruptcy Code sections). If a defendant's status as a "customer" of a financial institution results in that defendant being a "financial institution" under the Bankruptcy Code, the Section 546(e) safe harbor would apply to transfers by, to or for the benefit of that defendant. In a footnote, the Court specifically stated that the *Merit Management* decision does not address "what impact, if any, [the definition of "customer"] would have in the application of the §546(e) safe harbor." *See id*. at 5 n.2. This is a potential issue for litigants to consider in analyzing their defenses to an avoidance action.

If you have any questions, please contact one of the following attorneys.

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[1] The full text of §546(e) provides:

> 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 margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, 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, as defined in section 741(7), commodity contract, as defined in section 761(4), or

> forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

11 U.S.C.§546(e).

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