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A Notable Footnote In High Court Merit Management Decision

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On Feb. 27, 2018, the U.S. Supreme Court issued its decision in Merit Management Group LP v. FTI Consulting Inc.[1], resolving a circuit court split regarding the scope of the Bankruptcy Code's Section 546(e) "safe harbor," which protects certain securities-related transfers from avoidance. Much of the discussion surrounding the decision has characterized the ruling as a narrowing of the safe harbor, given the court's holding that a transfer is not protected from avoidance merely because the funds passed through a "financial institution" or other protected entity. However, footnote 2 of the decision — which states that the court's holding does not address whether a "customer" of a financial institution is encompassed within the statute, because the argument was not presented by the parties — could mean that the safe harbor remains applicable to additional participants in securities transactions, beyond those obviously covered under the statute. This article examines the strength of that argument.

Background

A unanimous Supreme Court held in Merit Management that Section 546(e) of the Bankruptcy Code protects securities-related transfers only if the end-to-end transfer is made by, to or for the benefit of enumerated protected entities. The decision had the effect of reversing prior decisions of five circuit courts of appeal that had held that Section 546(e) also protected transfers made through protected entities acting as intermediaries.[2] That pre-Merit Management regime had protected most securities transactions from avoidance, because the vast majority of securities-related transactions involve a transfer through at least one protected entity, such as a "financial institution," "stockbroker," or "securities clearing agency." By contrast, under Merit Management, securities transactions are protected only if the transferee or transferor is itself a protected entity (or if the transfer was made for the benefit of a protected entity).

However, the Merit Management scale-back may not be as extensive as it would first appear, due to the Bankruptcy Code's definition of "financial institution." That definition, provided in Section 101, includes entities that are commonly understood to be "financial," such as banks, savings and loan associations, trust companies, credit unions, and registered investment companies. But in addition to those entities, Congress included in the definition of "financial institution":

when any such [institution] is acting as an 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.[3]

In other words, customers of "financial institutions" are also protected entities under Section 546(e)'s safe harbor, limited only by the role of the institution as agent or custodian in connection with a securities contract.

The Supreme Court in Merit Management expressly recognized this aspect of the definition. In fact, during oral argument in Merit Management, Justice Stephen Breyer asked several pointed questions about why the defendants in that case did not claim that they were protected customers of a financial institution.[4] Counsel responded that he had no "good answer" to that question. Accordingly, the court simply noted in footnote 2 of Merit Management that "[t]he 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). ... We therefore do not address what impact, if any, § 101(22)(A) would have in the application of the § 546(e) safe harbor."[5]

Meaning of "Customer" in Section 101

The definition of "financial institution" has included a "customer" thereof ever since 1984, when Congress added "financial institution" to the Section 546(e) list of protected entities and the definition to Section 101.[6] In 2006, Congress added the clarifying parenthetical "(whether or not a 'customer', as defined in section 741)."[7] Notably, this parenthetical strongly suggests that Congress intended the "customer" of a financial institution to mean something other than the "customer" defined in Section 741.

So what does "customer" mean in Section 101? We have found virtually no case law considering this question. One decision from the bankruptcy appellate panel of the Ninth Circuit notes in an aside that the definition of financial institution includes not only "various [] banking entities," but also "a customer of the financial institution when the entity acts as agent for the customer in connection with a securities contract."[8] And we have located no legislative history that could shed light on the meaning.

In the absence of any further indication from the statute, "[i]t is a fundamental canon of statutory construction that, unless otherwise defined, words will be interpreted as taking their ordinary, contemporary, common meaning."[9] Such a meaning may be understood from a dictionary, including a dictionary contemporary to the enactment of the statute.[10]

Here, the ordinary, contemporary, common meaning of the word "customer" is broad. The 1987 Random House Dictionary's definition of customer was simply, "A person who purchases goods or services from another; buyer; patron."[11] The current Black's Law Dictionary definition is substantially the same: "A buyer or purchaser of goods or services."[12] As applied to a financial institution, a "customer" would therefore include not only an entity in an agency relationship with the financial institution, but also an individual who transacted in securities through a commercial bank. The Collier on Bankruptcy treatise agrees: "A fair reading of [the "customer"] clause would include, for example, a person who engages in securities contracts in his own name directly with a counterparty but transfers or receives the subject securities through a commercial bank or trust company acting as his custodian."[13]

Indeed, at oral argument in Merit Management, Justice Breyer appeared to apply the ordinary meaning of the word "customer." The transaction in Merit Management, in essence, involved funds passing from

an entity called Valley View Downs, or VVD, through Credit Suisse by way of a loan, to Citizens Bank (the escrow agent), and then to Merit Management, in exchange for stock passing from Merit Management through Citizens Bank to VVD. At oral argument, Justice Breyer asked,

[W]hen I look up the definition of financial institution, [Section 101] says that not only is it Credit Suisse and not only is it Citizens Bank, but it is also the customers of each of those financial institutions in an instance where the bank is acting as agent or custodian for a customer. Now, it seems to me that Citizens Bank is acting [as] agent or custodian of a customer ... and it seems to me that Credit Suisse is acting as — as an agent or custodian for VVD. So why doesn't that cover it?[14]

Although Justice Breyer's question may have limited precedential value, his application of "customer" suggests that he, too, saw no obvious limitations in interpreting the word according to its ordinary meaning.

Finally, while not dispositive, it is notable that other statutes pertaining to financial institutions also define "customer" broadly. For example, in the Graham-Leach-Bliley Act, "customer" means "with respect to a financial institution, any person (or authorized representative of a person) to whom the financial institution provides a product or service, including that of acting as a fiduciary."[15] Similarly, the Right to Financial Privacy Act defines "customer" as "any person or authorized representative of that person who is utilized or is utilizing any service of a financial institution, or for whom a financial institution is acting or has acted as a fiduciary, in relation to an account maintained in the person's name."[16] And the Uniform Commercial Code defines "customer" as "a person having an account with a bank or for whom a bank has agreed to collect items, including a bank that maintains an account at another bank."[17] Again, these statutes suggest that the word "customer" can easily reach an individual transacting in securities through a commercial bank.

Implications

Of course, bankruptcy trustees and plaintiff creditors will seek to define "customer" narrowly, while avoidance action defendants will seek to define "customer" broadly. Courts may have to develop indicia of a "customer," including but not limited to the existence of a contractual relationship, the assessment of any fees, or the nature of the products or services provided.

Separately, even if a defendant is a "customer," under Section 101, the defendant will have to show that the financial institution acted as an agent or custodian in connection with a securities contract to be eligible for the Section 546(e) safe harbor. Regardless, as Justice Breyer pointed out in his Merit Management questioning, defendants would argue that the safe harbor applies whether the "customer" was the transferor, the transferee, or the beneficiary of the transfer.

Finally, the plaintiff in Merit Management suggested the possibility of a temporal aspect of the definition. As the definition uses the present tense to describe "when any such [financial institution] is acting as agent or custodian for a customer," the plaintiff argued that the definition would only apply while the subject funds were still held at the financial institution (rather than after being distributed to the customer).[18] However, the Supreme Court's opinion did not address this issue.

After Merit Management, the inclusion of financial institutions' "customers" in the list of protected entities has taken on increased importance. This definition — and the scope of the safe harbor — will surely be tested in lower courts soon.

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[1] 138 S. Ct. 883 (2018).

[2] These were the Second, Third, Sixth, Eighth and Tenth Circuits. Two other circuit courts of appeal — the Seventh and Eleventh Circuits — held to the contrary. The Supreme Court's decision in Merit Management affirmed a Seventh Circuit decision below.

[3] 11 U.S.C. § 101(22)(A) (emphasis added).

[4] Transcript of Oral Argument at 15:23-19:18, Merit Management Group LP v. FTI Consulting Inc., 138 S. Ct. 883 (2018), https://www.supremecourt.gov/oral_arguments/argument_transcripts/2017/16-784_j5f0.pdf.

[5] 138 S. Ct. at 890 n.2.

[6] Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, Sec. 421(j)(4), 98 Stat. 368, codified at 11 U.S.C. § 101(19); Sec. 461(d), 98 Stat. 377, codified at 11 U.S.C. § 546(e). The original definition of "financial institution" was, "[A] person that is a commercial or savings bank, industrial savings bank, savings and loan association, or trust company and, when any such person is acting as agent or custodian for a customer in connection with a securities contract, as defined in section 741(7) of this title, such customer." 11 U.S.C. § 101(19) (1984).

[7] Financial Netting Improvements Act of 2006, Pub. L. No. 109-390, Sec. 5(a)(1)(A)(ii), 120 Stat. 2695, codified at 11 U.S.C. § 101(22)(A).

[8] In re Weisberg, 193 B.R. 916, 922 n.6 (B.A.P. 9th Cir. 1996),aff'd in part, rev'd in part on other grounds,136 F.3d 655 (9th Cir. 1998).

[9] Sandifer v. U.S. Steel Corp., 134 S. Ct. 870, 876 (2014) (internal quotation marks omitted).

[10] Id. at 876-77.

[11] Customer, Random House Dictionary (2d ed. 1987).

[12] Customer, Black's Law Dictionary (10th ed. 2014).

[13] 5 Collier on Bankruptcy ¶ 555.03 (16th ed. 2017).

[14] Transcript of Oral Argument at 16:2-14, supra note 4.

[15] 15 U.S.C. § 6827(1).

[16] 12 U.S.C. § 3401(5).

[17] U.C.C. § 4-104(a)(5).

[18] Transcript of Oral Argument at 35:1-17, supra note 4.