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Second Circuit reaffirms application of section 546(e) safe harbor

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The Second Circuit reaffirmed that the safe harbor of section 546(e) of the Bankruptcy Code protects transfers made in connection with a securities contract when a financial institution is acting as an agent in the challenged transfer.

On November 27, 2023, the Second Circuit reiterated that the safe harbor of 11 U.S.C. § 546(e) protects transfers made by, to, or for the benefit of a "customer" of a financial institution if the financial institution is acting as an agent in connection with a securities contract, but clarified that a court must test the applicability of the statutory safe harbor to each transfer in question, as opposed to the securities contract as a whole. *In re Nine West LBO Sec. Litig.*, 20-3257-cv (L) (Nov. 27, 2023). The Second Circuit also joined other courts in holding that the section 546(e) safe harbor defense is an affirmative defense, confirming that defendants bear the burden of demonstrating that the safe harbor applies to a challenged transfer.

Background

The Bankruptcy Code empowers a chapter 11 debtor or a trustee to bring claims to avoid certain pre-bankruptcy transfers of property. However, section 546(e) of the Bankruptcy Code provides a "safe harbor" that bars the avoidance of transfers that are made, *inter alia*, (1) "in connection with a securities contract" and (2) "by or to (or for the benefit of)" a qualifying entity enumerated in section 546(e), which list includes a "financial institution." (One exception is that section 546(e) does not apply to intentional fraudulent transfer claims under federal bankruptcy law.) The scope of the second requirement has been the subject of some debate.

In particular, because any transfer in connection with a "securities contract" or settling a securities transaction of any material size will be made literally "by or to" a financial institution as a conduit at some point in the transfer—wiring funds from an account at one bank to another, for example— section 546(e) had sometimes been applied to protect transfers even where none of the ultimate transferor, the ultimate transferee, or the ultimate beneficiary was a qualifying entity under section 546(e).

In 2018, the scope of section 546(e) was clarified when the Supreme Court held that it is not enough for a financial institution to merely touch the property at some point in the transfer; instead, the ultimate transferor, transferee, or beneficiary must be a qualifying entity for the safe harbor to apply. *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, 583 U.S. 366, 377–78 (2018). Without more, this holding would seem to narrow the universe of protected transfers. However, the *Merit Management* Court also observed that section 101(22)(A) of the Bankruptcy Code defines a qualifying "financial institution" not only to include traditional banks, trust companies, and the like, but also to include a *customer* of such a financial institution when the financial institution "is acting as agent or custodian for [the] customer … in connection with a securities contract." 583 U.S. at 373 n.2. In other words, in these circumstances, the customer itself would be a qualifying "financial institution."

Since *Merit Management*, parties and courts have relied on this argument to protect transfers where a financial institution acts as an agent or custodian for the ultimate transferor, transferee, or beneficiary in the transaction—thus preserving the impact of the legislative safe harbor in litigation concerning large, public securities transactions. For example, in 2019, the

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Second Circuit concluded that transfers made in connection with the Tribune Company's leveraged buyout were protected because Tribune was a customer of a "financial institution," Computershare, that acted as Tribune's agent with respect to payments made as part of the LBO. *In re Trib. Co. Fraudulent Conv. Litig.*, 946 F.3d at 77?78 & n.9. In determining that Computershare was Tribune's agent, the Second Circuit adopted the common law approach to agency. *Id.* at 79.

This "customer" approach has been subsequently considered and followed by other courts, including recently the Eighth Circuit. *See, e.g.*, *Kelley v. Safe Harbor Managed Account 101*, 31 F.4th 1058 (8th Cir. 2022); *Holliday v. Credit Suisse Sec. (USA) LLC*, 20-civ-5404 (GBD), 2021 WL 4150523 (S.D.N.Y. Sept. 13, 2021); *In re SunEdison, Inc.*, 620 B.R. 505 (Bankr. S.D.N.Y. 2020); *In re Boston Generating LLC*, 617 B.R. 442 (Bankr. S.D.N.Y. 2020).

The Second Circuit's *Nine West* decision

In 2014, Sycamore Partners acquired Jones Group (the parent company of Nine West and other retailers) through an LBO. Wells Fargo, a "financial institution" as defined in the Code, was hired to act as a paying agent to distribute LBO payments to public shareholders (the "Public Shareholders"). Separately, Jones Group's directors, officers, and employees (the "Individual Shareholders") would be paid for their shares through Jones Group's payroll processor, which plaintiff argued is not a "financial institution" as defined in the Code.

Nine West filed for bankruptcy in 2018; thereafter, a litigation trustee pursued certain estate causes of action, including fraudulent transfer claims against the Public Shareholders and the Individual Shareholders. In 2020, Judge Rakoff of the U.S. District Court for the Southern District of New York dismissed the fraudulent transfer claims against both groups. Judge Rakoff concluded that all of the LBO payments were protected because Nine West was a customer of Wells Fargo and that Wells Fargo was an agent in connection with a "securities contract," *i.e.*, the merger agreement effecting the LBO (a "contract-by-contract" analysis). The litigation trustee appealed to the Second Circuit.

On November 27, 2023, the Second Circuit affirmed the district court's ruling with respect to payments to the Public Shareholders, but reversed with respect to the payments to the Individual Shareholders.

The *Nine West* panel disagreed with the breadth of the district court's analysis as it applied to the Individual Shareholders, holding instead that a financial institution must have acted as agent or custodian in connection with a particular transfer in order for that transfer to fall within the safe harbor (a "transfer-by-transfer" analysis). The Circuit held that Wells Fargo acted as an agent for the transfers made to the Public Shareholders (*e.g.*, by distributing payments to these shareholders), and thus those transfers were protected; however, no "financial institution" acted as an agent for the transfers made to the Individual Shareholders (*e.g.*, the payroll processor distributed these payments), and thus those transfers were not protected. Judge Sullivan dissented in part, writing that the district court's broader "contract-by-contract" analysis was the correct approach under the plain text of the relevant statutes.

The Second Circuit ruled on two additional legal issues: (1) it joined other courts in holding that the section 546(e) safe harbor is an affirmative defense, and (2) it reaffirmed its analysis in *Tribune* holding that section 546(e) preempts state law claims that seek the same remedy as fraudulent transfer claims, here, unjust enrichment claims seeking to recover the payments to Public Shareholders.

Key takeaways

Nine West is an important addition to the universe of appellate decisions interpreting section 546(e) after *Merit Management*.

- Perhaps most importantly, the Second Circuit reaffirmed its holding in *Tribune*: section 546(e) safe harbors transfers made to an entity that is a "customer" of a financial institution, and courts in the Second Circuit will apply the common law test for agency to determine whether the financial institution is acting as the customer's agent.
- The Second Circuit confirmed that section 546(e) is an affirmative defense on which the defendant bears the burden of demonstrating that the challenged transfers qualify for the safe harbor. Accordingly, if section 546(e) is raised at the motion to dismiss stage, the facts demonstrating the defense must be ones that can be considered at that stage—generally facts alleged in the complaint or appearing in documents incorporated into the complaint (*e.g.*, transaction documents).
- Finally, *Nine West* adopted a "transfer-by-transfer" approach to the application of the "customer" prong of the Bankruptcy Code's definition of "financial institution." This may have a limited effect on large transfers in connection with transactions in public securities. However, going forward, some transfers might not be safe-harbored from challenges in courts within the Second Circuit if no financial institution acts as agent with respect to those specific

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transfers, even if the transfers are made in connection with an LBO or other securities transaction.

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