Supreme Court Interprets Scope of Section 546(e) Safe Harbor

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Unanimous Court in *Merit Management Group, LP v. FTI Consulting, Inc.*, No. 16-784, resolves circuit court split, holds that the Bankruptcy Code's Section 546(e) safe harbor protects only transfers by, to, or for the benefit of protected entities.

In an opinion dated February 27, 2018, the Supreme Court unanimously affirmed a Seventh Circuit decision and held that Section 546(e)'s safe harbor protects transfers from avoidance only if the transfer sought to be avoided is a transfer by, to, or for the benefit of a "protected entity," an entity enumerated in 546(e) (for example, a "financial institution" as defined by Section 101(22) of the Bankruptcy Code). Where a protected entity is neither the transferee, transferor, or beneficiary of the transfer, a transfer will not be protected even if the property transferred passed through a financial institution or other protected entity acting as an intermediary.

The Supreme Court's *Merit Management* ruling resolves a longstanding circuit split on the application of Section 546(e). Prior to the Supreme Court's decision, the Second, Third, Sixth, Eighth, and Tenth Circuits had all held that the safe harbor protects transfers that occur through protected entities acting only as intermediaries. Until the Seventh Circuit's decision in 2016, only the Eleventh Circuit had previously held that Section 546(e) did <u>not</u> safe-harbor transfers for which a protected entity acted only as an intermediary.

The decision may have wide-ranging implications regarding the finality of securities transactions and, in particular, tender offers, leveraged buyouts, and other transactions that have been challenged in bankruptcy proceedings.

The Section 546(e) Safe Harbor

Section 546(e) of the Bankruptcy Code provides a safe harbor that protects certain transfers from avoidance (other than as a transfer made with actual intent to hinder, delay, or defraud creditors as set forth in Section 548(a)(1)(A)). To qualify for Section 546(e)'s safe harbor, a transfer must meet two requirements, one that turns upon the category of transfer, and a second that turns on the parties to the transfer. First, the transfer sought to be avoided must be a margin payment, settlement payment, or transfer in connection with a securities contract, commodity contract, or forward contract. Second, the transfer must be made by, to, or for the benefit of a protected entity (a list of which is set forth in the text of 546(e)).[1] If the transfer meets both requirements, it cannot be avoided under Sections 544, 545, 547, 548(a)(1)(b) or 548(b) of the Bankruptcy Code.[2]

[1] The categories of protected entities are "a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency," each as defined Section 101 of the Bankruptcy Code.

[2] Although not at issue in *Merit Management*, 546(f) and 546(g) provide for similar safe harbors for transfers in connection with repurchase agreements and swap agreements.

Background

Merit Management arises out of a 2007 transaction whereby Valley View Downs, LP ("Valley View"), purchased all of the stock of Bedford Downs Management Corporation ("Bedford Downs") for $55 million. In brief, upon closing, Valley View wired the $55 million purchase price from its account at Credit Suisse to Citizens Bank, which served as escrow agent. Citizens Bank subsequently distributed the $55 million to Bedford Downs shareholders, including $16.5 million (in two installments) to Bedford Downs shareholder Merit Management Group, LP ("Merit"). Valley View later filed for Chapter 11 bankruptcy along with its parent company, Centaur, LLC. FTI Consulting, Inc. ("FTI"), in its capacity as trustee of the Centaur, LLC litigation trust (the successor-in-interest to Valley View), sued Merit Management in the U.S. District Court for the Northern District of Illinois to avoid the $16.5 million transfer as a constructively fraudulent transfer.

In 2015, the District Court dismissed FTI's constructive fraudulent transfer claims on the ground that the payment to Merit was protected by Section 546(e). 541 B.R. 850 (N.D. Ill. 2015). The District Court first concluded that the transfer from Valley View to Merit was a "settlement payment" or a payment "in connection with a securities contract" that qualified for protection under Section 546(e). *Id.* at 858. Relying on precedent from the Second, Third, Sixth, Eighth, and Tenth Circuits, the District Court concluded that Section 546(e) applied because Credit Suisse and Citizens Bank—two financial institutions—served as intermediaries, meaning that the transfer was "by" or "to" a financial institution and thus within the Section 546(e) safe harbor. *Id.* at 855-58.

FTI appealed to the Seventh Circuit, which reversed and remanded. 830 F.3d 690 (7th Cir. 2016). In an opinion written by Chief Judge Diane Wood, the Seventh Circuit concluded that Section 546(e)'s statutory language was "unclear whether the safe harbor was meant to include intermediaries, or if it is limited to what we might think of as the real parties in interest—here, the first and the final party possessing the thing transferred." *Id.* at 693. The Court of Appeals ultimately concluded that Section 546(e) does not apply to transfers between entities that are not covered by 546(e) in which a covered entity acts only as "conduit," joining the Eleventh Circuit in the minority position and sharpening the split among the circuits.

Supreme Court Decision

In a unanimous decision written by Justice Sonia Sotomayor, the Court held that the "overarching transfer" that the trustee seeks to avoid, rather than underlying component transfers, determines whether the Section 546(e) safe harbor applies. (Slip Op. at 19.) In the case of Merit Management, the parties did not dispute that a transfer from Valley View to Merit had occurred, and it was this "overarching transfer" that the trustee sought to avoid. Merit did not contend that either of Valley View or Merit was a "financial institution" or other covered entity. Accordingly, the relevant transfer fell outside the scope of the safe harbor because it was not a transfer by, to, or for the benefit of a protected entity.

The Court reached its conclusion that Section 546(e) must be tested against the transfer sought to be avoided by examining the language and structure of the avoidance powers of Chapter 5 of the Bankruptcy Code. Because both Section 546(e) and the avoidance provisions (§§ 544, 545, 547, and 548, for example) refer to "a transfer," the Court concluded that the transfer to be protected by Section 546(e) must be the transfer that would otherwise be subject to avoidance. (Slip Op. at 11.) Similarly, because Section 546(e) protects transfers that are "settlement payments" or made "in connection with a securities contract," the Court concluded that the transfer to be avoided must be a transfer that "*is*" either a settlement payment or in connection with a securities contract, rather than a transfer that "involves," or "comprises" such a transaction. (Slip Op. at 12-13.)

Although a focus on the trustee's characterization of a transfer appears to give the trustee significant flexibility to plead around Section 546(e)'s safe harbor, but the Court dismissed this concern, noting that the statutory elements of avoidance actions carefully define what a trustee may characterize as an avoidable transfer. Similarly, the Court noted that avoidance action defendants are free to argue that a trustee has failed to properly account for "the role of component parts" of an allegedly avoidable transfer. (Slip Op. at 13-14.) In *Merit Management*, the transfer sought to be avoided was the overarching transfer from the debtor, as buyer, to Merit, as selling shareholder. Had the trustee sought to avoid a transfer to a protected entity, the Court expressly stated that the safe harbor protections shield that transfer from avoidance even if the protected entity acted only as a conduit or intermediary: "If the transfer that the trustee seeks to avoid was made 'by' or 'to' a securities clearing agency [one category of covered entity] . . . , then §546(e) will bar avoidance, *and it will do so without regard to whether the entity acted only as an intermediary*." (Slip Op. at 17) (emphasis added).

While the full impact of the Court's decision will be apparent only upon development in the lower courts, *Merit Management* is a significant change in the law in the several circuits in which transfers through protected entities had previously been safe-harbored. There are, however, a few predictions that may be made at this point:

- The most immediate impact of *Merit Management* may be that certain transactions that would have fallen within the safe harbor under the law of the Second, Third, Sixth, Eighth, and Tenth circuits may now be subject to avoidance claims. Estate representatives such as litigation trustees, debtors in possession, and creditors' committees can be expected to point to *Merit Management* as justification to bring new claims to avoid transfers previously protected.
- We expect that the question of whether a trustee or other estate representative has improperly cut intermediate steps out of a transfer may receive greater focus in avoidance litigation. *Merit Management* creates an incentive for defendants that are not covered entities to argue that the trustee has failed to properly account for intermediate transfers to covered entities that would result in the transfer sought to be avoided being a safe-harbored transfer "to" a covered entity.
- The Court left open the question of whether a party that is not otherwise a protected party can avail itself of protected party status by structuring its transactions so that it is a "customer" of a financial institution that acts as its agent or custodian in the transaction, within the definition of "financial institution" under Bankruptcy Code Section 101(22)(A) (which, generally speaking, includes commercial banks but not broker-dealers), as this question was not briefed before the Court.
- *Merit Management* clarifies application of the Section 546(e) safe harbor to covered entities acting as intermediaries. Because the Court expressly stated that a transfer to a covered entity is protected whether the entity acts as a principal or as an intermediary, covered entities named as recipients of a transfer should not be required to demonstrate that they received the transfer as a principal to secure dismissal under 546(e).

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