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Supreme Court to determine scope of Section 546(e) safe harbor provisions

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DECEMBER 14, 2017

The U.S. Supreme Court heard oral arguments Nov. 6 in *Merit Management Group LP v. FTI Consulting Inc.* as it prepares to resolve a circuit split over whether Section 546(e) of the Bankruptcy Code prohibits avoidance of a transfer made by or to a financial institution regardless of whether the institution has a beneficial interest in the transferred property. *Merit Mgmt. Grp. LP v. FTI Consulting Inc.*, No. 16-784, *oral argument held*, 2017 WL 5133893 (U.S. Nov. 6, 2017).

The case is on appeal from the 7th U.S. Circuit Court of Appeals, which held that when the financial institution acts as a mere conduit, the safe harbor does not apply.

Sections 548(a) and 544(b) of the Bankruptcy Code allow a trustee to avoid two types of fraudulent transfers: those made with actual fraudulent intent, and those that are "constructively" fraudulent.

Constructive fraud is established if the transfer was for less than a reasonably equivalent value and either was made while the debtor was insolvent or rendered the debtor insolvent.

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In constructive fraud cases, Section 546(e) provides a safe harbor that prohibits the trustee from avoiding transfers that are "margin payment[s]" or "settlement payment[s]" "made by or to (or for the benefit of)" certain qualifying entities, including commodity brokers, securities clearing agencies and "financial institutions."[1]

The safe harbor also protects transfers "made by or to (or for the benefit of)" the same types of entities "in connection with a securities contract."[2]

Section 546(e) does not provide a safe harbor from actually fraudulent transfers. However, actual fraud is hard to prove, and many fraudulent transfer cases focus on proof of constructive fraud.

Accordingly, if Section 546(e) is interpreted expansively, many otherwise avoidable constructively fraudulent transfers would be immunized from attack, to the detriment of the vast majority of the debtor's unsecured creditors.

Section 546(e) was designed to "'minimize the displacement caused in the commodities and securities markets in the event [of] a major bankruptcy affecting the industries,' and to 'prevent the ripple effects created by the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected industry.'"[3]

CASE HISTORY

The *Merit Management* case arose out of a stock buyout involving two private firms, neither of which was a qualifying entity under Section 546(e).

As part of a deal to establish a racino (a combination race track and casino), Valley View Downs paid $55 million in exchange for the stock in Bedford Downs, a competing racino operator.

Merit Management Group LP held about a third of the stock in Bedford, and it was paid around $16 million for its shares. Unfortunately, the Bedford stock later proved to be worth far less than the $55 million paid by Valley View, and Valley View arguably was insolvent or rendered insolvent. Thus, the purchase of Merit's stock was vulnerable as a constructively fraudulent transfer. Valley View ultimately failed to get the necessary gambling license for its racino and wound up in bankruptcy.

Valley View did not buy the stock directly from the Bedford shareholders. Instead, as is common, financial institutions were used as conduits to effectuate the purchase.

Valley View borrowed money from Credit Suisse to purchase the shares. That money passed through Citizens Bank of Pennsylvania, which acted as an escrow agent. Thus, the funds went from Credit Suisse to Citizens Bank to Merit.

Neither Credit Suisse nor Citizens Bank was beneficially interested in any of the funds transferred; they simply facilitated the transfer. Valley View and Merit were the real parties in interest.

FTI Consulting Inc., in its capacity as the liquidating trustee of the *In re Centaur LLC et al.* Litigation Trust (which includes Valley View as one of the debtors) sought to avoid the payment to Merit as a constructively fraudulent transfer.

Merit raised the Section 546(e) safe harbor in defense. There was no question that the transfer at issue in this case was either a "settlement payment" or a payment made "in connection with a securities contract."

The only question was whether the payment was "made by or to" a financial institution within the meaning of the safe harbor, since the funds were initially transferred by Credit Suisse and passed through Citizens Bank to Merit.

The 7th Circuit sided with precedent from the 11th U.S. Circuit Court of Appeals and parted company with five other circuits in holding that a financial institution must have a beneficial interest in the transferred funds or securities for the safe harbor to apply.[4]

Since Citizens Bank and Credit Suisse served as mere conduits between the real parties in interest, Valley View and Merit had no beneficial interest in the transaction and the safe harbor did not protect Merit, the 7th Circuit said.

According to the appeals court, the qualifying financial institutions themselves must be targets of the fraudulent transfer action.

It makes no sense, the court reasoned, for a purely private firm such as Merit to be afforded immunity from a fraudulent transfer clawback simply because of the happenstance that a financial institution — which itself is not potentially liable for the fraud — was used to transfer the money to buy the stock. As a result, the purchase price was not transferred by or to a financial institution, Thus, the trustee could avoid it.

This approach contrasts with the approach adopted by the 2nd, 3rd, 6th, 8th and 10th circuits, which have held that such transfers may qualify for the safe harbor even if the financial institution at issue is merely a conduit.[5]

Those circuits took a simplistic plain meaning view of Section 546(e), reasoning that the financial institutions need only be involved in transferring the funds.

WHAT'S AT STAKE

The outcome of this case may impact entities that act on behalf of others, such as securities clearing agencies, brokers, trust companies and indenture trustees, and the parties on whose behalf these institutions act.

It also will affect the ability of trustees ability to achieve a central objective of the Bankruptcy Code, which is to avoid and recover constructively fraudulent transfers for the benefit of creditors. In addition, the case could impact bankruptcies in which trustees seek to unwind failed leveraged buyouts.

If the Supreme Court reverses the 7th Circuit and holds that the safe harbor applies even in mere conduit situations such as the one in *Merit Management*, then a large percentage of even private buyouts will be immune from fraudulent transfer attack.

Former shareholders facing clawbacks in the cases of bankrupt Tribune Co. and Lyondell Chemical Co. filed an amicus brief in *Merit Management*, as did the National Association of Bankruptcy Trustees.

In their brief, the former Tribune and Lyondell shareholders argued that the Section 546(e) safe harbor expressly applies whenever a settlement payment is made "by" or "to" a qualifying entity, such as a financial institution, regardless of whether that entity had a beneficial interest in the securities or the settlement payment.

To hold otherwise, they argued, goes contrary to the purpose of the safe harbor and "would destabilize the market by exposing investors and intermediaries to increased risk and thereby discourage investment and capital formation."[6]

By contrast, in its amicus brief, the National Association of Bankruptcy Trustees urged the court to reject an over-expansive construction of the safe harbor and stated that the transfer from Valley View to Merit is exactly the type of constructively fraudulent transfer that trustees have the power to avoid.

"Nothing in the legislative history of Section 546(e) suggests that Congress intended to insulate the ultimate recipients of such transfers from liability so long as they use a bank rather than gold bar or a briefcase full of cash,"[7] the trustees said.

Therefore, according to the trustees, the 7th Circuit should be affirmed based on its sensible construction of both the purpose of and the plain language of Section 546(e).

ARGUMENT BEFORE THE SUPREME COURT

The main issue in *Merit Management* is how to apply the Section 546(e) safe harbor in situations where funds pass through a financial intermediary in the course of the transaction, when the financial institution itself is not a real party in interest and is not potentially liable for the fraudulent transfer. Is the mere fact that the monies passed through such a financial institution enough to trigger the safe harbor?

From the outset, the justices seemed receptive to the 7th Circuit's position and skeptical of a broader reading that would immunize nonfinancial institutions from fraudulent transfer attack simply because a financial institution was involved in the money transfers.

Justice Anthony Kennedy asked why an exemption protecting a "settlement" payment should apply if "that's not the transfer here the trustee seeks to avoid."[8] That is, he suggested that the safe harbor should protect only the listed financial entities themselves from fraudulent transfer attack.

Justice Ruth Bader Ginsburg also went to the heart of the matter early on, asking, "Why it should matter whether the transmission was through the banks rather than handed over by Valley View to Merit?"[9]

Throughout the argument, the justices expressed concern over adopting a broad view of the safe harbor that could apply to all kinds of transfers, such as payments by check, or transfers of stock, whenever a bank or financial institution is involved.

Merit argued that the court should not disregard financial institutions and impose liability on an ultimate beneficiary of transaction.

This approach, according to Merit, would be inconsistent with the plain language of Section 546(e), which protects both transfers "by or to" financial institutions and transfers "for the benefit of" financial institutions. That language shows that the financial institution need not be beneficially interested, since that was but one of two alternative bases for triggering the safe harbor, Merit argued.

The trustee countered that it only makes sense for the safe harbor to apply with respect to the transfer the trustee is seeking to avoid. If, as here, the end-to-end transfer is between two non-financial institutions, then the Section 546(e) safe harbor does not apply, it said.

In perhaps one of the most interesting exchanges of the day, Justice Elena Kagan inquired as to the conspicuous absence of an amicus brief from the solicitor general.

Counsel for the trustee seized the opportunity to point out the similar absence of financial institutions, stockbrokers or clearing agencies as amici, noting that if what the trustee was urging on the court "was really a catastrophe for the markets or something else, boy, I sure think the SG would be here, you know, waving at least a yellow flag."[10]

THE TAKEAWAY

How the Supreme Court decides *Merit Management* will determine whether a significant class of potentially avoidable constructive fraudulent transfers between purely private nonfinancial institutions are immune from attack because of the safe harbor of Section 546(e).

The justices appeared to view the relevant transfer as the overarching transfer from Valley View to Merit, as opposed to the final leg of the transaction from the intermediary to Merit.

While the outcome of the case of course is not certain, the justices' focus on the end-to-end transfer to Merit strongly suggests that a majority of the court will affirm the 7th Circuit's narrow application of the safe harbor provision.

Under that narrow view, the safe harbor would apply only if the qualifying financial institution listed in the safe harbor were itself the real party in interest with respect to the transfer that the bankruptcy trustee was seeking to avoid.

If, on the other hand, the justices reverse the 7th Circuit and adopt the broader view, it would limit a trustee's power to avoid transfers that meet certain conditions, i.e., any avoidable transactions could suddenly become unavoidable if a bank or financial institution is involved. The justices, however, seemed reluctant to impose such limits.

NOTES

[1] 11 U.S.C.A. § 546(e).

[2] *Id.*

[3] H.R. Rep. No. 97-420 (1982).

[4] *FTI Consulting Inc. v. Merit Mgmt. Grp. LP,* 830 F.3d 690, 691, 697 (7th Cir. 2016), *cert. granted,* 137 S. Ct. 2092 (2017).

[5] *See id.* at 697 (citing *In re Quebecor World (USA) Inc.,* 719 F.3d 94 (2d Cir. 2013); *Contemporary Indus. Corp. v. Frost,* 564 F.3d 981, 987 (8th Cir. 2009); *In re QSI Holdings Inc.,* 571 F.3d 545, 551 (6th Cir. 2009); *In re Resorts Int'l Inc.,* 181 F.3d 505, 516 (3d Cir. 1999); *In re Kaiser Steel Corp.,* 952 F.2d 1230, 1240 (10th Cir. 1991)).

[6] Brief for Various Former Tribune and Lyondell Shareholders as Amici Curiae in Support of the Petitioner at 4, *Merit Mgmt. Grp. LP v. FTI Consulting Inc.* (U.S. July 20, 2017) (No. 16-784).

[7] Brief for the National Association of Bankruptcy Trustees as Amicus Curiae at 3, *Merit Mgmt. Grp. LP v. FTI Consulting Inc.* (U.S. Sept. 18, 2017) (No. 16-784).

[8] Transcript of Oral Argument at 4, *Merit Mgmt. Grp. LP v. FTI Consulting Inc.* (U.S. Nov. 6, 2017) (No. 16-784).

[9] *Id.* at 5.

[10] *Id.* at 61.

This article first appeared in the December 14, 2017, edition of Westlaw Journal Bankruptcy.

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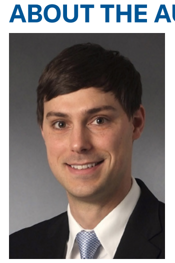

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