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U.S. Supreme Court Clarifies Scope of Securities Safe Harbor

By Stuart I. Gordon and Matthew V. Spero*

The U.S. Supreme Court has ruled that the transfer subject to the securities safe harbor of Bankruptcy Code Section 546(e) is the transfer that a bankruptcy trustee seeks to avoid, and not intermediary transfers to "mere conduits."

The U.S. Bankruptcy Code permits a bankruptcy trustee to avoid certain prepetition transfers by a debtor, subject to specific exceptions. One such exception—the securities safe harbor in Bankruptcy Code Section 546(e)[1]—was at the heart of a recent decision by the U.S. Supreme Court that resolved a circuit split and clarified how the securities safe harbor exception operates.

In *Merit Management Group, LP v. FTI Consulting, Inc.*,[2] the Court considered application of the safe harbor in the context of a transfer executed through various intermediaries or conduits in a series of transactions. The Court, in a unanimous decision authored by Justice Sonia Sotomayor, held that courts must look to the transfer that the trustee seeks to avoid to determine whether that transfer meets the safe harbor criteria, and not to the component parts of the transfer.

BACKGROUND

Bankruptcy Code Sections 544 through 553 outline the circumstances that allow a trustee to pursue avoidance.[3] If a transfer is avoided, Section 550

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* Stuart I. Gordon, a partner at Rivkin Radler LLP and a member of the Board of Editors of *Pratt's Journal of Bankruptcy Law*, represents financial institutions, insurance companies, real estate owners and developers, retailers, manufacturers, distributors, restaurants, physicians and medical practices, non-profits, unions, and health and welfare funds in insolvency cases throughout the United States. Matthew V. Spero, a partner in the firm, represents creditors, lenders, principals, landlords, creditors' committees, and debtors in business reorganizations, restructurings, acquisitions, and liquidations before the bankruptcy courts in the Eastern and Southern Districts of New York, as well as in out-of-court workouts. The authors can be reached at stuart.gordon@rivkin.com and matthew.spero@rivkin.com, respectively.

[1] 11 U. S. C. § 546(e).

[2] *Merit Management Group, LP v. FTI Consulting, Inc.*, 138 S. Ct. 883, 200 L. Ed. 2d 183 (2018).

[3] *See*, *e.g.,* 11 U. S. C. § 544(a) (setting out circumstances under which a trustee can avoid unrecorded liens and conveyances); § 544(b) (detailing power to avoid based on rights that unsecured creditors have under nonbankruptcy law); § 545 (setting out criteria that allow a

identifies the parties from whom the trustee may recover either the transferred property or the value of that property to return to the bankruptcy estate.[4]

The Bankruptcy Code sets limits on the exercise of the trustee's avoiding powers, one of which is the safe harbor provisions of Section 546(e). The Section 546(e) safe harbor 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.

THE CASE

The *Merit* case arose in 2003 when two companies—Valley View Downs, LP, and Bedford Downs Management Corporation—were competing for a harness-racing license that was necessary to open a racetrack casino in Pennsylvania. In 2005, the Pennsylvania State Harness Racing Commission denied both applications. In 2007, the Pennsylvania Supreme Court upheld those denials, but allowed both companies to reapply for the license.

The companies reached an agreement under which Bedford Downs would withdraw as a competitor for the harness-racing license and Valley View agreed to purchase all of Bedford Downs' stock for $55 million after Valley View obtained the license.

The Pennsylvania Harness Racing Commission awarded Valley View the license, and Valley View proceeded with the acquisition of the Bedford Downs stock. Toward that end, Valley View arranged for the Cayman Islands branch of

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trustee to avoid a statutory lien); § 547 (detailing criteria for avoidance of preferential transfers).

[4] Section 550(a) provides that "to the extent that a transfer is avoided . . . the trustee may recover . . . the property transferred, or, if the court so orders, the value of such property" from "the initial transferee of such transfer or the entity for whose benefit such transfer was made" or from "any immediate or mediate transferee of such initial transferee."

Credit Suisse to finance the $55 million purchase price as part of a larger $850 million transaction.

Credit Suisse wired the $55 million to Citizens Bank of Pennsylvania, which had agreed to serve as the third-party escrow agent for the transaction. The Bedford Downs shareholders, including Merit Management Group, LP, deposited their stock certificates into escrow pursuant to the agreement.

At the closing, in October 2007, Valley View received the Bedford Downs stock certificates and Citizens Bank disbursed $47.5 million to the Bedford Downs shareholders, with $7.5 million to remain in escrow at Citizens Bank through the end of the multiyear indemnification holdback period provided for in the agreement.

In October 2010, Citizens Bank disbursed the $7.5 million from escrow to the Bedford Downs shareholders at the conclusion of the holdback period. In total, Merit received approximately $16.5 million from the sale of its Bedford Downs stock to Valley View. The closing statement for the transaction reflected Valley View as the "Buyer," the Bedford Downs shareholders as the "Sellers," and $55 million as the "Purchase Price."

Valley View, however, did not open a racetrack casino but, instead, filed a Chapter 11 petition, as did its parent company, Centaur, LLC. The bankruptcy court thereafter confirmed a plan of reorganization and FTI Consulting, Inc., was appointed trustee of the Centaur litigation trust.

FTI (as trustee) sued Merit in the U.S. District Court for the Northern District of Illinois, seeking to avoid the $16.5 million transfer from Valley View to Merit for the sale of Bedford Downs' stock. FTI's complaint alleged that the transfer was constructively fraudulent under Bankruptcy Code Section 548(a)(1)(B) because Valley View was insolvent when it purchased, and "significantly overpaid" for, the Bedford Downs stock.

Merit moved for judgment on the pleadings, contending that the Section 546(e) safe harbor barred FTI from avoiding the Valley View-to-Merit transfer. According to Merit, the safe harbor applied because the transfer was a "settlement payment . . . made by or to (or for the benefit of)" a covered "financial institution" within the meaning of Section 546(e)—in this case, two financial institutions: Credit Suisse and Citizens Bank.

The district court granted Merit's motion, reasoning that the Section 546(e) safe harbor applied because the financial institutions had transferred or received funds in connection with a "settlement payment" or "securities contract."

The U.S. Court of Appeals for the Seventh Circuit reversed, holding that the Section 546(e) safe harbor did not protect transfers in which financial institutions served as mere conduits.

The Supreme Court granted certiorari to resolve a conflict among the circuit courts as to the proper application of the Section 546(e) safe harbor.[5] The issue before the Court was whether the transfer between Valley View and Merit implicated the safe harbor exception because the transfer was "made by or to (or for the benefit of) a . . . financial institution."

Merit contended that the Court should look not only to the Valley View-to-Merit end-to-end transfer, but also to all its component parts, which included one transaction by Credit Suisse to Citizens Bank (that is, the transfer of the $16.5 million from Credit Suisse into escrow at Citizens Bank), and two transactions by Citizens Bank to Merit (that is, the transfer of $16.5 million over two installments by Citizens Bank as escrow agent to Merit). Because those component parts included transactions by and to financial institutions, Merit contended that Section 546(e) barred avoidance.

FTI argued that the only relevant transfer for purposes of the Section 546(e) safe harbor was the overarching transfer between Valley View and Merit of $16.5 million for purchase of the stock, which was the transfer FTI, as trustee, sought to avoid. Because that transfer was not made by, to, or for the benefit of a financial institution, FTI contended that the safe harbor provision did not apply.

THE SUPREME COURT'S DECISION

The Court affirmed the Seventh Circuit.

In its decision, the Court agreed with FTI and ruled that the relevant transfer for purposes of the Section 546(e) safe harbor was the overarching transfer that the trustee sought to avoid—namely, the $16.5 million transfer between Valley View and Merit.

To reach that conclusion, the Court turned to the text of Section 546(e), finding that it made "clear" that the starting point for the Section 546(e) inquiry was the substantive avoiding power under the provisions expressly listed in the "notwithstanding" clause and, consequently, the transfer that the trustee sought to avoid as an exercise of those powers.

[5] *Cf. In re Quebecor World (USA) Inc.*, 719 F.3d 94, 99 (2d Cir. 2013) (finding the safe harbor applicable where covered entity was intermediary); *In re QSI Holdings, Inc.*, 571 F.3d 545, 551 (6th Cir. 2009) (same); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 987 (8th Cir. 2009) (same); *In re Resorts Int'l, Inc.*, 181 F.3d 505, 516 (3d Cir. 1999) (same); *In re Kaiser Steel Corp.*, 952 F.2d 1230, 1240 (10th Cir. 1991) (same), *with In re Munford, Inc.*, 98 F.3d 604, 610 (11th Cir. 1996) (*per curiam*) (rejecting applicability of safe harbor where covered entity was intermediary).

Moreover, the Court noted that the very last clause in Section 546(e)—"except under section 548(a)(1)(A) of this title"—was a reminder that the focus of the inquiry was the transfer that the trustee sought to avoid because it created an exception to the exception, providing that "the trustee may not avoid a transfer" that met the covered transaction and entity criteria of the safe harbor, "except" for an actually fraudulent transfer under Section 548(a)(1)(A). According to the Court, by referring back to a specific type of transfer that fell within the avoiding power, "Congress signaled that the exception applies to the overarching transfer that the trustee seeks to avoid, not any component part of that transfer."

The Court held that the statutory language and the context in which it was used all pointed to the transfer that the trustee sought to avoid as the relevant transfer for purposes of the Section 546(e) safe harbor.

Applying that interpretation of the safe harbor provision to this case yielded what the Court determined was a "straightforward result." FTI, the trustee, sought to avoid the $16.5 million Valley View-to-Merit transfer. FTI did not seek to avoid the component transactions by which that overarching transfer was executed. As such, the Court reasoned, when determining whether the Section 546(e) safe harbor saved the transfer from avoidance liability—that is, whether it was "made by or to (or for the benefit of) a . . . financial institution"—it had to look to the overarching transfer from Valley View to Merit to evaluate whether it met the safe harbor criteria. The Court found that because the parties did not contend that either Valley View or Merit was a "financial institution" or other covered entity, the transfer fell outside of the Section 546(e) safe harbor.

The Credit Suisse and Citizens Bank component parts were "simply irrelevant to the analysis" under Section 546(e), according to the Court. The focus, the Court concluded, "must remain on the transfer the trustee sought to avoid."

CONCLUSION

The Court's decision makes clear, once and for all, how to apply the safe harbor in Section 546(e). By narrowing the application of Section 546(e), more transactions likely will be avoidable in the future than under the test espoused by Merit. By adopting the Seventh Circuit's position, the Court has rejected what had come to be the majority view, which will require the courts in those circuits to adapt and adopt this new legal interpretation.