SUPREME COURT LIMITS SECURITIES SAFE HARBOR IN BANKRUPTCY CLAWBACKS

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Section 546(e) of the Bankruptcy Code shelters a "settlement payment" that is made "by or to (or for the benefit of)" a securities market intermediary, such as a financial institution, from avoidance in bankruptcy except in cases of actual fraud.[1] The safe harbor was originally enacted in 1982 to protect financial markets from the instability caused by the unwinding of settled securities transactions. Congress believed that, in the absence of protection, there would be an inordinate amount of risk that the insolvency of one counterparty could trigger a chain reaction of insolvencies in the settlement and clearing industry and thereby undermine the integrity of financial markets.

The United States Supreme Court, in *Merit Management Group, LP v. FTI Consulting, Inc.*,[2] resolved a circuit split over the scope of the Bankruptcy Code's securities safe-harbor provision,[3] concluding that a transfer can be undone in bankruptcy even if the financial institution served as a mere conduit. The unanimous Court rejected the rule previously followed by most federal appellate courts, which immunized transfers when the financial institution acted solely as an intermediary (*e.g.*, escrow or disbursing agent) in the transaction and did not have a beneficial interest in the property transferred.[4] The Court held that the only relevant transfer for purposes of the securities safe harbor is the transfer that the trustee actually seeks to avoid.

Factual background

In *Merit*, Valley View Downs, LP agreed to purchase the stock of Bedford Downs Management Corporation for $55 million to eliminate a rival racetrack and casino operator. Credit Suisse (a financial institution) financed the acquisition and wired the funds directly to Citizens Bank (another financial institution), the agreed-upon escrow agent. The shareholders of Bedford Downs deposited all of the stock certificates with Citizens Bank as part of the transaction. Citizens Bank then transferred the purchase price to the shareholders of Bedford Downs and Merit Management Group, LP received a $16.5 million distribution from Citizens Bank for its shares. The money passed through two financial institutions, but neither held a beneficial interest in the funds transferred.

Valley View, which became the sole shareholder of Bedford Downs, eventually filed for Chapter 11 bankruptcy. FTI Consulting, Inc. was appointed trustee of a litigation trust that was created under the confirmed plan and sued Merit to recover the funds it received as a fraudulent transfer.[5] FTI argued that the only relevant transfer for purposes of determining the applicability of the securities safe harbor of §546(e) is the transfer the trustee seeks to avoid and identity of the recipient of that transfer. If the recipient of that relevant transfer was not a financial institution or other market intermediary protected by the statute, the safe harbor does not apply. The fact that protected financial institutions were used as intermediaries to effect the overarching transfer should not change the result.

Merit, on the other hand, asserted that the statute could not be parsed in that fashion. The safe harbor protects the *transaction* as a whole and must be analyzed as encompassing all of its component parts. In this case, the transfers that were made "by or to" the protected financial institutions preceded the transfer to Merit. The intermediate transfers were integrally related to the transaction as a whole and should not be ignored in favor of an isolated, end-to-end transfer analysis. Merit's position was consistent with the decision of most courts of appeal that applied the safe harbor even though the financial institutions were mere conduits, because the transfers were made "by or to" those institutions in the course of executing the entire transaction.

Supreme Court decision

The Supreme Court ruled in favor of FTI and found that the transfer to Merit was not protected from avoidance. The High Court held that under a "plain meaning" reading of the statute, the focus when analyzing the applicability of the §546(e) safe harbor should be on the transfer targeted for avoidance—the "relevant" transfer—and on the defendant from whom that transfer is sought to be recovered. The statute "provides that the transfer that is saved from avoidance is one 'that *is*' (not one that involves) a securities transaction." In other words, to qualify for protection under the securities safe harbor, the otherwise avoidable transfer itself must be a transfer that meets the criteria for the safe harbor rather than the component transfers that make up the larger transaction.[6] If a transaction involves multiple transfers (A→B→C→D) and the trustee seeks only to avoid the ultimate transfer (A→D), then the safe harbor is only applied and analyzed with respect to the targeted transfer, not the intervening component parts of the transfer (B→C). As such, if the recipient of the overarching transfer targeted for avoidance ("D" or, in this case, Merit) is not a financial institution or other entity covered by the safe harbor, there is no shield from liability.

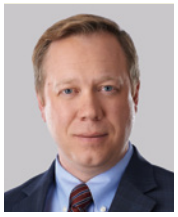
The Court's ruling is consistent with the economic realities of the transaction. The financial institutions involved had no beneficial interest in the challenged payment. The presence of financial institutions in the chain of transfers is irrelevant and does not implicate the safe harbor when the targeted transfer is made to or for the benefit of an entity not protected by the statute. In other words, the Court held that §546(e) protects transfers *to* an institution covered by the statute, not *through* such an institution when it acts only as an intermediary or conduit for the ultimate transfer.

Conclusion

The Supreme Court in *Merit* rejected the expansive view of §546(e) embraced by most appellate courts and limited the scope of the securities safe harbor. The statute has now been definitively interpreted to require the focus to be on the targeted transfer and the affected parties involved in the targeted transfer (*i.e.*, the end-to-end parties, A→D). Section 546(e) shields financial institutions and other market intermediaries from being defendants in protected avoidance actions, but no longer shelters the transactions themselves—even if it involves those parties. As such, parties can no longer avoid the risk of clawback in bankruptcy by simply structuring the transaction to launder the payment through a financial institution.

Viewing the statute in a manner that harmonizes the application of the safe harbor and the transfer targeted for avoidance furthers the principles of bankruptcy without implicating any of the concerns for which the statute was enacted.[7] The class of transactions subject to avoidance risk in bankruptcy has, in the wake of *Merit*, grown. Selling shareholders in securities buyouts that involve financial intermediaries now face the risk that the transactions are subject to challenge, which may lead to increased recoveries for creditors in bankruptcy. Buyers and sellers of securities must now give greater attention to the value given in exchange for payment than to the form of the transaction.

The scope of the safe harbor will continue to be tested in the courts notwithstanding *Merit*. Notably, the Supreme Court commented in a footnote that Merit did not contend that it qualified as a protected "financial institution" under the § 546(e) safe harbor by virtue of its status as a "customer" of a financial institution.[8] The Court therefore declined to address the impact, if any, that the inclusion of a financial institution's customers in the list of protected entities under statute would have on the application of the safe harbor.[9] ▲



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Notes

[1] 11 U.S.C. §546(e).

[2] 138 S. Ct. 883 (2/27/2018).

[3] *Compare In re Tribune Co. Fraudulent Conveyance Litigation,* 818 F.3d 112 (2d Cir. 2016); *In re Quebecor World (USA) Inc.*, 719 F.3d 94, 99 (2d Cir. 2013) (finding safe harbor applicable where the financial institution served as an intermediary in the transaction); *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 FTI Consulting, Inc. v. Merit Management Group, LP*, 830 F.3d 690, 695 (7th Cir. 2016) (rejecting conduit theory and looking to economic substance of transaction); *In re Munford, Inc.*, 98 F.3d 604, 610 (11th Cir. 1996) (*per curiam*) (rejecting applicability of safe harbor where the financial institution served only as an intermediary).

[4] The safe harbor was applied by many courts in a manner that shielded transactions posing no threat to the integrity of the securities settlement process or the financial markets. Ralph Brubaker, *Understanding the Scope of the Securities Safe Harbor Through the Concept of the "Transfer" Sought to Be Avoided*, 37 Bankr. Law Letter 1 (July 2017).

[5] FTI brought the claim under §548(a)(1)(B) and §544(b)(1) of the Bankruptcy Code, asserting that the debtor was insolvent at the time of the transaction and received less than reasonably equivalent value in exchange for the stock.

[6] The Supreme Court reasoned that an expansive reading of the safe harbor "put the proverbial cart before the horse." *Merit Management Group, LP v. FTI Consulting, Inc.*, 138 S. Ct. 883, 891 (2018). Instead, "the court must first identify the relevant transfer to test." *Id.* The Court found that "[t]he language of §546(e), the specific context in which that language is used, and the broader statutory structure all support the conclusion that the relevant transfer for purposes of the § 546(e) safe-harbor inquiry is the overarching transfer that the trustee seeks to avoid under one of the substantive avoidance provisions." *Id.*

[7] The Supreme Court rejected policy-based arguments for a broad construction of the safe harbor: "As Congress and the [Securities and Exchange Commission] have a recognized, permitting plaintiffs to unwind multibillion-dollar transactions, involving transfers between thousands of different market participants a decade earlier, would inject substantial uncertainty and increase exposure into a system that demands certainty and finality." *Brief of Various Former Tribune and Lyondell Shareholders as Amici Curiae in Support of Petition,* 2017 WL 3098281 *26 (filed 7/20/2017). *See Merit,* 138 S. Ct. at 896 (Merit argued that Congress intended a "comprehensive approach to securities and commodity transactions" that "was prophylactic, not surgical" and meant to achieve finality for the parties to a covered transaction) (quoting Brief of Petitioner 41-43) .

[8] *Id.* at 890 n.2. *See* 11 U.S.C. § 101(22)(A), §546(e) (providing that where a financial institution is acting as agent or custodian for a "customer" in connection with a securities contract, the customer itself is a protected financial institution).

[9] Bankruptcy trustees and plaintiff creditors will seek to define the term "customer" under the statute narrowly in order to avoid the application of the §546(e) safe harbor, while avoidance action defendants will seek a broad definition in order to come within the class of entities protected under the statute.