U.S. SUPREME COURT TO REVIEW SCOPE OF “SETTLEMENT PAYMENT DEFENSE” FOR BANKRUPTCY CLAWBACK SUITS

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On May 1, 2017, the U.S. Supreme Court announced that it would review the Seventh Circuit's decision in *FTI Consulting, Inc. v. Merit Management Group, LP*, 830 F.3d 690 (7th Cir. 2016) ("*Merit*"), which addressed the scope of the safe harbor found in Section 546(e) of the Bankruptcy Code for settlement payments. Litigation over the § 546(e) safe harbor has been on the rise in the last several years, as evident in the many high-profile bankruptcy suits to avoid, or "claw back," payments from failed brokerages and investment banks (*e.g., Madoff, Lehman Brothers*) and to unwind shareholder payments in leveraged buy-outs (LBOs) that later went south (*e.g., Tribune, Lyondell*). The defenses against these suits have been furious, as the payee classes have been numerous (some suits have named hundreds or thousands of defendants and have even been styled as "defendant class actions"), the dollar amounts enormous (often in the hundreds of millions and even billions of dollars), and the stakes high, as "clawback" suits aim to disgorge payments from investors and funds that might have long since distributed the moneys elsewhere. [1]

This makes the Supreme Court's decision to hear the Merit case even more important for parties trading in the securities and commodity markets. Congress enacted the § 546(e) safe harbor and similar safe harbors for repurchase agreements ("repos"), swaps, and other financial contracts (under §§ 546(f)–(j) and 555–562 of the Bankruptcy Code) to protect the securities and commodity markets from the immediate impact of bankruptcy filings. The safe harbors both allow market participants to quickly close out trading positions with distressed companies and protect a large class of market players (banks, brokers, clearinghouses, and high-volume traders) from disruptive avoidance actions in the bankruptcy cases. The circuit courts have been split, however, on how broad Congress intended the protections from "clawback" actions to be: for only those market players (banks, brokers, clearinghouses, and high-volume traders), or do those protections also cover anyone receiving payments *through* those market players (*e.g.*, when a bank or broker is acting as a so-called "conduit")? Depending on how the Supreme Court resolves this circuit split, the range of targets in bankruptcy "clawback" suits could be radically expanded or contracted.

Below, we examine the contours of the Bankruptcy Code § 546(e) safe harbor, the Seventh Circuit's decision in *Merit*, and the decisions of other circuit courts, which provide the backdrop against which the Supreme Court will rule as to the scope of the § 546(e) safe harbor going forward.

BANKRUPTCY CODE § 546(E)

Bankruptcy Code § 546(e), commonly referred to as the "settlement payment defense," provides that:

> 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 ... or settlement payment ... *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, ... commodity contract, … or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

(Emphasis added.) The provisions cited in the introductory clause (§§ 544, 545, 547, 548(a)(1)(B), and 548(b) of the Bankruptcy Code) refer to the clawback powers of the bankruptcy estate under federal and state law, which are usually exercised in fraudulent transfer and preference suits. The exception in the final clause (§ 548(a)(1)(A) of the Bankruptcy Code) refers to intentional fraudulent transfer suits, which avoid transfers that were intentionally made by a company to defraud or delay its creditors.

Thus, with the exception of claims for intentional fraudulent transfer, Bankruptcy Code § 546(e) protects all "settlement payments" made "*by or to (or for the benefit of)*" the listed entities from avoidance during a bankruptcy case.[2] The reason for this safe harbor is straightforward: as described by the Second Circuit, "[u]nwinding settled securities transactions" through avoidance claims brought months or years after the transactions closed "would seriously undermine . . . markets in which certainty, speed, finality, and stability are necessary to attract capital."[3] Accordingly, and consistent with these goals, most — though as discussed below, not all — courts have interpreted the Bankruptcy Code § 546(e) safe harbor broadly.

THE SPLIT IN THE CIRCUIT COURTS OF APPEALS

While the underlying purpose of the § 546(e) safe harbor is clear, the various federal Circuit Courts of Appeals have split on their interpretation of the safe harbor's clause providing that settlement payments must be made "*by or to (or for the benefit of)*" the types of entities listed in § 546(e) (financial institutions, stockbrokers, commodity brokers, forward contract merchants, financial participants, or securities clearing agencies). In particular, the circuit courts have divided on whether the safe harbor is available only for settlement payments that are for the benefit of the entities listed in § 546(e) or whether that safe harbor is *also* available for any settlement payments that pass *through* these types of entities to others (*i.e.*, ultimate beneficiaries who may not be specifically listed in § 546(e)).

For example, in a series of cases, the Second Circuit has held that the safe harbor protects settlement payments that merely pass through "conduit" financial institutions to ultimate beneficiaries.[4] The Third, Sixth, Eighth, and Tenth Circuit Courts of Appeals have all reached the same conclusion.[5]

In so ruling, each of the circuit courts noted above expressly distinguished a prior Eleventh Circuit decision, which was then the only circuit court to hold that the § 546(e) safe harbor does *not* protect settlement payments that merely pass through "conduit" financial institutions to ultimate beneficiaries.[6] In rejecting *Munford*, each of the Second, Third, Sixth, Eighth, and Tenth Circuits relied heavily on the plain language of the § 546(e) safe harbor, which merely requires that settlement payments be made "by or to" the entities listed in § 546(e). Thus, the

Munford position was viewed as an outlier that had not attracted the Supreme Court's attention, at least until the Seventh Circuit weighed in with its *Merit* decision in July 2016.

THE SEVENTH CIRCUIT'S *MERIT* DECISION

In *Merit*, the Seventh Circuit acknowledged that the payments at issue — a buyout of shareholders as part of an acquisition — were settlement payments under § 546(e), but differed from the Second, Third, Sixth, Eighth, and Tenth Circuits in its assessment of whether those settlement payments were nevertheless made "by or to (or for the benefit of)" the entities listed in § 546(e). Specifically, the Seventh Circuit found that language in § 546(e) to be ambiguous and "turn[ed] to the statute's purpose and context for further guidance."[7] There, the Seventh Circuit determined that a variety of provisions of the Bankruptcy Code — including Sections 544, 547, 548, and 550 — supported the interpretation, rejected by all circuit courts except the Eleventh, that the § 546(e) safe harbor applies only to transfers where one of the entities listed in § 546(e) (financial institutions, stockbrokers, commodity brokers, forward contract merchants, financial participants, or securities clearing agencies) "is a debtor or actual recipient of a transfer, rather than simply a conduit for funds."[8]

IMPLICATIONS OF SUPREME COURT REVIEW

The Supreme Court has now accepted review of the *Merit* decision to resolve the split between the Second, Third, Sixth, Eighth, and Tenth Circuits, on the one hand, and the Seventh and Eleventh Circuits on the other.

The stakes for the Supreme Court's Merit decision are extremely high, not just for the bankruptcy bar but also for investors and financial institutions generally. Bankruptcy cases feature strong competing interests between:

unpaid creditors, consisting of the "bankruptcy estate" — represented by the debtor company itself (or "debtor-in-possession"), a trustee if one is appointed, and the official committee of unsecured creditors — and the various lenders, suppliers, employees, and others, all of whom seek to collect as many assets as possible to fund their recoveries; and

entities that have conducted business with the debtor company in the past, who unsurprisingly are not eager to have their past transactions challenged and unwound as a possible funding source for creditors.

Congress attempted to strike a balance between these competing interests in the various Bankruptcy Code safe harbors described above, and the financial markets have adapted accordingly. Lenders, traders, and suppliers now routinely try to fit transactions within the safe harbors to avoid possible later litigation if their counterparties seek bankruptcy protection — for example, by refashioning their financing contracts as repos or swaps, or their commodity supply contracts as forward contracts or swaps, and expressly inserting contract language that the parties intend the safe harbors to apply. Moreover, the broad reading of Bankruptcy Code § 546(e)'s settlement payment defense by most circuit courts has given market participants some comfort that LBOs and other common securities transactions will not be vulnerable to unwinding based on later downturns.

But the breadth of the safe harbor language has now created an interpretive problem that the Supreme Court will tackle. How the Supreme Court rules in Merit will be closely watched. A ruling that confirms the approach of the majority of circuit courts will essentially ratify the status quo, while possibly frustrating bankruptcy estates seeking to maximize their recoveries for creditors. A ruling that follows the Seventh and Eleventh Circuits could encourage more aggressive bankruptcy clawback litigation and possibly force an adjustment in market practices to protect against such suits — since the universe of possible clawback defendants could be increased exponentially, namely to all investors, investment funds, traders, and suppliers except those entities specifically listed in Bankruptcy Code § 546(e). How the Supreme Court ultimately balances this basic tension in the Bankruptcy Code — between the maximization of creditor recoveries and the protection of the financial markets — remains to be seen.

Notes:

[1] For example, the *Tribune* clawback suit, still ongoing, seeks to disgorge over $8 billion in LBO payments made in 2007 to over 5,000 shareholders.

[2] The listed entities include "financial participants," which are defined in § 101(22A) of the Bankruptcy Code as clearing organizations and any entities meeting certain thresholds of market exposure in repos, swaps, forward contracts, securities and commodity contracts, and related netting agreements: either $1 billion in gross notional or actual principal amount outstanding, or $100 million in gross mark-to-market positions, in each case measured at the time of entering into a safe-harbor contract or during the 15 months prior to the debtor counterparty's bankruptcy filing.

[3] *In re Tribune Co. Fraudulent Conveyance Litigation*, 818 F.3d 98, 119 (2d Cir. 2016).

[4] *See In re Tribune Co. Fraudulent Conveyance Litigation*, 818 F.3d 98, 106, 119 (2d Cir. 2016) (finding safe harbor protected settlement payments made to public shareholders of a public company being taken private in a leveraged buy- out transaction, where the LBO payments were distributed through a securities clearing agency or other financial institution acting as intermediaries); *In re Quebecor World (USA) Inc.*, 719 F.3d 94, 99–100 (2d Cir. 2013) (finding safe- harbor protected settlement payments where a financial institution was a trustee for an exchange between two private entities); *see also Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329, 338–39 (2d Cir. 2011) (similarly, recognizing that it "would appear inconsistent" with Bankruptcy Code § 546(e)'s plain language to provide that it applies to settlement payments made "by or to (or for the benefit of)" financial market participants but excludes payments that do not involve a financial intermediary taking title to the securities).

[5] *See In re Plassein Int'l Corp.*, 590 F.3d 252, 258–59 (3d Cir. 2009); *In re Resorts Int'l, Inc.*, 181 F.3d 505, 515–17 (3d Cir. 1999); *In re QSI Holdings, Inc.*, 571 F.3d 545, 550–51 (6th Cir. 2009); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 986–88 (8th Cir. 2009); *In re Kaiser Steel Corp.*, 952 F.2d 1230, 1240–41 (10th Cir. 1991).

[6] *See Matter of Munford, Inc.*, 98 F.3d 604, 610 (11th Cir. 1996).

[7] *See FTI Consulting, Inc.*, 830 F.3d at 693.

[8] *See id.* at 696.

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